

Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising

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REDRAWING THE PUBLIC-PRIVATE BOUNDARIES IN ENTREPRENEURIAL CAPITAL RAISING

Robert B. Thompson† & Donald C. Langevoort††

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INTRODUCTION

Congress enacted the Jumpstart Our Business Startups (JOBS) Act in 2012 amidst a perceived crisis in entrepreneurial capital raising.¹ The number of initial public offerings (IPOs)—long the gold standard for capital raising by successful emerging companies—has dropped off considerably in the last decade.² Companies not yet large or successful enough to consider an IPO complain about the obstacles

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¹ See Jumpstart Our Business Startups Act, Pub. L. No. 112–106, 126 Stat. 306 (2012) (to be codified in scattered sections of 15 U.S.C.).

² See *The Endangered Public Company: The Big Engine That Couldn’t*, ECONOMIST, May 19, 2012, at 28 (reporting a drop of thirty-eight percent in the number of public companies since 1997 and a drop in the number of yearly IPOs from an average of 311 in the 1980–2000 period to 81 in 2011).

associated with finding early-stage capital from venture capitalists or “angel” investors just in trying to get off the ground.³ Loosening up on the securities laws’ regulatory burdens was the chosen legislative solution, demonstrating a political willingness to trade off some level of investor protection in order to promote capital formation and its hoped-for payoff, job creation.

We can hardly be sure this will work because we do not yet understand enough to explain why IPOs have dropped in numbers or why capital formation has apparently come under such stress. It could have more to do with structural changes in our knowledge-based economy or the shifting preferences and sentiments of consumers and investors than with regulatory costs.⁴ Even if we focus on regulation, it is far from clear which regulations most need pruning. Regulatory effects are often dimly understood.⁵ Complaints by entrepreneurs about unnecessary costs can help spot inefficient regulatory requirements; however, they can also mask a self-serving effort on the part of those entrepreneurs to gain a bigger share of the private benefits of corporate control through diminished disclosure and accountability, all simply under the pretext of job creation.

Before the JOBS Act had taken on any political momentum, the two of us embarked on a project to remap the public-private boundaries under the securities laws in light of the remarkable technological change that has taken place in recent decades. This change is interesting because it creates opportunities for innovative, hybrid forms of capital raising and securities trading that do not fit neatly within traditional regulatory boundaries. With the new legislation, we now have the opportunity to examine critically how the new ideas that Congress has given us either fit with or alter that map. The JOBS Act plainly creates more space on the less (or un-) regulated private side of the line, where we think—for better or worse—its biggest long-term impact will be.

This Article focuses on the Securities Act of 1933 (‘33 Act), which regulates public capital-raising transactions.⁶ Essentially, the ‘33 Act requires issuers and their affiliates to register public offerings with the Securities and Exchange Commission (SEC).⁷ The registration template comprises four parts that are characteristic of American securi-

³ See Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 6–7 (2012).

⁴ See Jay R. Ritter et al., *Where Have All the IPOs Gone?* (Dec. 17, 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=1954788>.

⁵ See generally Charles K. Whitehead, *The Goldilocks Approach: Financial Risk and Staged Regulation*, 97 CORNELL L. REV. 1267 (2012) (arguing that because their effects are difficult to predict, regulations should be applied incrementally).

⁶ See 15 U.S.C. §§ 77a–77c (2006 & Supp. V 2011).

⁷ See 15 U.S.C. § 77f (2006 & Supp. V 2011).

ties regulation more generally: (1) mandatory disclosure to potential investors; (2) preoffering review of those disclosures by a specialized government agency (the SEC); (3) restrictions on the selling process so as to give the disclosures sufficient potency to generate informed investment decisions; and (4) liability threats to enforce each of these interventions and promote high-quality disclosure.⁸

There are two boundaries of particular importance, both of which are under considerable pressure. First, some offerings of securities are exempt from '33 Act requirements because they are "private" or otherwise limited in terms of size, scope, or nature of investors being solicited.⁹ These exemptions had been reasonably well understood, at least until the JOBS Act, but were always somewhat controversial. The second boundary lies between securities transactions regulated by the '33 Act on the one side and companies and transactions regulated by the Securities Exchange Act of 1934 ('34 Act)¹⁰ on the other. Once complete, any offering—whether registered or exempt—places securities in investors' hands. Absent regulatory or contractual restriction, we can expect resales to occur soon thereafter. When there is large enough supply and demand, trading markets will emerge to support trading by investors among themselves. The '34 Act provides various investor protections for traders, including extensive disclosure and increasingly, corporate governance requirements for issuers of actively traded securities. But it does so differently from the '33 Act, and often with less regulatory intensity, for reasons we will explore.

For issuers who make registered public offerings under the '33 Act, the transition to the '34 Act arena is largely seamless because the very act of '33 Act registration places the issuer in the '34 Act regime¹¹ (as does listing on a national securities exchange like the New York Stock Exchange (NYSE) or NASDAQ, which almost always accompanies a registered public offering).¹² For issuers who have not (yet) made a public offering, on the other hand, the situation is quite different, and this is what originally piqued our interest. In the last period prior to its IPO, Facebook offered a particularly salient illustration of this as it sought to raise capital from a sizeable number of private investors who would be bundled in a single investment vehi-

⁸ See SEC, Form S-1, *available at* <http://www.sec.gov/about/forms/forms-1.pdf>.

⁹ See 15 U.S.C. §§ 77c–77d (2006 & Supp. V 2011).

¹⁰ 15 U.S.C. §§ 78a–78pp (2006 & Supp. V 2011).

¹¹ See 15 U.S.C. § 78o(d) (2006 & Supp. V 2011) (subjecting companies who have made a registered public offering to periodic disclosure requirements).

¹² See 15 U.S.C. §§ 78l(b), 78m(a), 78n(a) (2006 & Supp. V 2011) (subjecting companies with a class of equity securities registered on a securities exchange to periodic disclosure and proxy regulation).

cle.¹³ So long as the issuer's own capital-raising transactions were truly exempt, the issuer would be free of the burdensome '33 Act obligations. But what about resales? In recent years, nonexchange trading markets like SharesPost and SecondMarket, among others, popped up to facilitate resales—and thereby provide liquidity—without turning private issuers into public ones so as to give rise to disclosure obligations under the '34 Act.¹⁴ Moreover, the single-investment vehicle kept the issuing company's number of shareholders from rising above the threshold for public status.¹⁵ The JOBS Act addressed the legal gymnastics required to avoid '34 Act status,¹⁶ although it did not do this particularly well. We have explored this particular issue elsewhere, along with the JOBS Act's separate encouragement of registered IPOs for emerging growth companies (accomplished by offering them a somewhat deregulated "on-ramp" into the '34 Act regulatory system).¹⁷

As we began thinking through the legal gymnastics of facilitating private secondary trading while avoiding the '34 Act, we noticed other places where similar innovations were occurring that enabled issuers to avoid the burdens of '33 Act registration by bypassing a traditional registered public offering. There has been much publicity recently about "reverse mergers"—especially those involving Chinese firms—wherein a private company instantly achieves public status in U.S. trading markets by merging into a shell company that, conveniently, has already been registered with the SEC under the '34 Act (even though registration offers no information of value because it describes an empty shell).¹⁸ That such actions are often referred to as "back-door registrations" strongly hints at the regulatory arbitrage going on here. These are commonplace transactions—a fact that has attracted special regulatory and political attention for geopolitical reasons¹⁹—

¹³ See Donald C. Langevoort & Robert B. Thompson, "Publicness" in *Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 338 (2013).

¹⁴ See Ibrahim, *supra* note 3, at 21–23; Elizabeth Pollman, *Information Issues on Wall Street 2.0*, 161 U. PA. L. REV. 179, 193–202 (2012); Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 556–57 (2012).

¹⁵ See 15 U.S.C. §§ 78l(g), 78m(a), 78n(a) (subjecting companies with shareholders and assets above the threshold numbers to periodic disclosure and proxy regulation).

¹⁶ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012) (amending 15 U.S.C. § 78l(g)(1)(A)) (raising the threshold number of record shareholders from 500 to 2000 so long as no more than 499 are nonaccredited investors).

¹⁷ See Langevoort & Thompson, *supra* note 13, at 342. For different suggestions addressing this set of problems, see Michael D. Guttentag, *Patching a Hole in the JOBS Act: How and Why to Rewrite the Rules that Require Firms to Make Periodic Disclosures*, 88 IND. L.J. 151 (2013).

¹⁸ See Leslie A. Gordon, *Red-Flagging China: Regulators Eye Chinese Companies Using Reverse Mergers to Enter U.S.*, A.B.A. J., Oct. 2011, at 17.

¹⁹ See Dinny McMahon & Andrew Ackerman, *SEC Wrestles With China: Deloitte Case Highlights Agency's Frustration with Beijing*, WALL ST. J., Sept. 10, 2011, at B13; Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Speech at the Council of Institutional Investors

and hundreds of millions of dollars of securities become public through the back door each year.²⁰

Reverse mergers, in turn, may lead to another type of financing transaction: a "Private Investment in Public Equity" (PIPE) deal, which allows the issuer (which is often distressed) to finance itself through a private placement with one or more investors. In such a deal, the private investors require the issuer to file a '33 Act registration statement to support their resales to public investors. The curiosity here is that the resale registration statement is deemed a secondary transaction (that is, one by the investors and not the issuer), which gains simplified regulatory treatment falling short of what conventional issuer registration would involve. The result, essentially, is an indirect public offering in the '33 Act sense of that term but without the usual liability protections that would accrue to investors in a traditionally underwritten public offering.

Neither of these innovative transaction types has received the critical scholarly attention it deserves,²¹ which we will try to remedy in Part II. Understanding these transactions in the transition space between the '33 and '34 Acts necessarily requires a better-developed theory of publicness: Which companies should be subjected to the obligations of one or both of the statutes? And, after eighty years, have the ideas of publicness in the two regimes finally converged so that distinctive treatment makes no sense? In Part I, we develop our view that the value added by the '33 Act lies in addressing the special selling efforts needed to stimulate demand for a large quantity of stock. The reverse mergers and PIPE transactions treated in Part II are best analyzed this way even though they are clothed in a transactional setting that takes advantage of the less intense regulation of the '34 Act. What is striking is that reverse mergers and PIPEs became standard transactional devices even though they seemingly skimp on traditional investor protections, particularly as they relate to the diligence that deal participants must display, without the SEC having for-

Spring Meeting: Facilitating Real Capital Formation (Apr. 4, 2011), available at <http://www.sec.gov/news/speech/2011/spch040411laa.htm>.

²⁰ As discussed *infra* note 123 and accompanying text, the SEC has recently approved revised NASDAQ listing standards for reverse merger issuers, which will no doubt reduce the attractiveness of this technique. There was no change, however, to the legal standards for reverse mergers themselves.

²¹ William Sjostrom deserves much credit for his work in this area. See generally William K. Sjostrom, Jr., *The Truth About Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L.J. 743 (2008) [hereinafter Sjostrom, *Truth About Reverse Mergers*] (discussing reverse mergers); William K. Sjostrom, Jr., *PIPEs*, 2 ENTREPRENEURIAL BUS. L.J. 381 (2007) [hereinafter Sjostrom, *PIPEs*] (discussing the increasing use of PIPEs and the SEC's response to them); see also William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?*, 53 FLA. L. REV. 529, 531 (2001) [hereinafter Sjostrom, *Internet Direct Offerings*] (discussing how companies can circumvent the normal process for offerings using underwriters by making offerings online).

mally (that is, through rule) recognized their existence. Well after they became commonplace, the SEC shifted its policy as to them in certain respects. Our claim is that this is an illustration of a too-frequent phenomenon: creative lawyers and their clients claim open spaces created by technological change and aggressive marketplace innovation by assuming favorable regulatory treatment, which the SEC only becomes fully aware of after the practice has already been established and when it is very hard to undo the occupation. That is precisely what had happened in the private secondary markets,²² and so we thought that the similarities in these otherwise different ways of negotiating the public-private divide were worth noting.

With the passing of the JOBS Act, our inquiry expanded. Of the Act's various '33 Act reforms, we think that by far the most important is the elimination of the ban on general solicitation with respect to Rule 506 private offerings to accredited investors. Coupled with liberalizations in the private resale markets, this may well dramatically change the way early-stage (and maybe even later-stage) capital raising occurs. Thus in Part III, after briefly examining two other JOBS Act reforms (crowdfunding and the new "Reg A+" exemption), we use the template we develop for analyzing reverse mergers and PIPEs to test the revised Rule 506 exemption against the concerns that underlie the '33 Act and to question whether something important in investor protection has been lost in the process of statutory reform. As with the transactions in Part II, we see in the new Rule 506 an absence of due diligence obligations long thought necessary to constrain the increasingly aggressive sales practices that we can expect once the ban on general solicitation disappears.

Part IV asks whether the restraints on sales and marketing that we have examined as part of what justifies the '33 Act might be addressed better with a more technology-driven, forward-looking rethinking of how we regulate sales practices in the securities industry. They would, but this is only possible with far more regulatory resources than are likely to be forthcoming from Congress.

I

THE MAJOR LANDMARKS AND CONTESTED TERRITORIES

A. The Securities Act of 1933

The '33 Act regulates public offerings by issuers and their affiliates by combining the four pillars already identified, all imposed in response to the history of perceived abuses and havoc for investors in

²² See Langevoort & Thompson, *supra* note 13, at 385.

the years leading up to the Great Depression.²³ First, it requires the creation of a registration statement, a public disclosure document that reveals a great deal of information about the issuer and its capital-raising plans.²⁴ Second, it provides for review of the registration statement by the SEC staff to ensure its quality and completeness.²⁵ This review is a powerful one because the issuer cannot lawfully sell its securities until the registration statement becomes “effective,” the timing of which is largely under bureaucratic control.²⁶

Third, the marketing of the offering is restricted to assure that the selling process does not get out ahead of the required disclosure and so cause investors to commit to purchasing the newly issued securities before they have an opportunity to consider the disclosure about the issuer and its prospects.²⁷ The ’33 Act regulates the roles of various intermediaries in the selling process (e.g., underwriters, accountants, and, more indirectly, lawyers), anticipating enhanced due diligence that will protect investors.²⁸ This marketing restriction is intensely complicated because it tries to balance two inconsistent goals in a very compressed time period: one, allowing the issuer and underwriters on the selling side to build a solid book of committed investors to price the securities accurately and limit the risk associated with the distribution and two, simultaneously giving to the investors on the buying side the practical ability to think through the disclosures (always a work in progress until the effective date) before committing to the deal. Though outside the main thrust of our article, the JOBS Act makes changes here that may turn out to be surprisingly profound.²⁹

²³ The ’33 Act passed during the first hundred days of President Franklin Roosevelt’s administration. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 69–72 (3d ed. 2003).

²⁴ See 15 U.S.C. § 77g (2006 & Supp. V 2011) (setting out information required in a registration statement).

²⁵ See 15 U.S.C. § 77h (2006) (describing the effective date of a registration statement and SEC review).

²⁶ See, e.g., 17 C.F.R. §§ 230.460–.461 (2013) (describing agency action regarding acceleration of the effective date).

²⁷ See, e.g., 15 U.S.C. § 77e(b)–(c) (2006) (limiting offers during the prefilings period and regulating offers during the waiting period).

²⁸ See 15 U.S.C. § 77k(b) (2006) (specifying obligations for underwriters and auditors to avoid liability for misrepresentations in registration statements).

²⁹ The JOBS Act seeks to facilitate public offerings by “emerging growth companies,” a category that includes most first-time registrants. See *Jumpstart Our Business Startups Act*, Pub. L. No. 112-106, § 101, 126 Stat. 306, 307 (2012) (to be codified at 15 U.S.C. § 77b(a)). One well-publicized change is the ability of such companies to “test the waters” by approaching institutional investors prior to filing their registration statement. Another is that brokerage firms can initiate research coverage in advance of the offering. While that too, was well publicized, less attention has been paid to how Congress accomplished this. Among other things, the JOBS Act changes the key definition of “offer” in section 2(a)(3) to hold that research does not constitute an offer for purposes of section 5(c). *Id.* § 105. In the same subsection, it then defines research extremely broadly to include oral,

Finally, there is liability. In addition to the SEC's tools to police compliance (e.g., refusals to declare a registration statement effective, stop orders, and enforcement actions), the '33 Act creates three extraordinarily powerful liability standards.³⁰ Section 11 creates strict liability for the issuer if there are material misstatements or omissions in the registration statement when it becomes effective and due diligence-based liability for other offering participants.³¹ Section 12(a)(1) enforces the registration obligation and marketing restrictions, again strictly, against any seller.³² Section 12(a)(2) extends due diligence-like liability to any material misrepresentations or omissions in any selling efforts connected to the public offering.³³ The public-offering context is well suited to class action treatment, both economically and legally, so that the threat to issuers and other participants in the distribution is particularly potent.³⁴

The combination of these intense legal requirements and the practical need to appeal to a sufficient number of investors makes a public offering an extraordinarily stressful event. Outsiders—lawyers, accountants, and investment bankers—temporarily gain a high degree of control over the issuer to manage both deal risk and legal risk.³⁵ This is a rite of passage for an issuer going from private to public as it opens itself to an unfamiliar level of external governmental and marketplace influence. In other words, these are the initial demands of publicness.³⁶

written, and electronic communications recommending the security. *Id.* Read literally, that allows any broker-initiated publicity and marketing prior to the filing of a registration statement, no matter how aggressive. We are indebted to Jim Cox for raising this point.

³⁰ SEC tools include stop orders, injunctions, and various other remedies provided for in the statute. See 15 U.S.C. §§ 77h, 77h-1, 77s, 77t (2006 & Supp. V 2011).

³¹ See 15 U.S.C. § 77k.

³² See 15 U.S.C. § 77l(a)(1) (2006).

³³ See 15 U.S.C. § 77l(a)(2).

³⁴ Section 11 permits any person acquiring a security covered by a registration statement with a material misstatement to recover from a series of defendants with no reliance usually required and causation or due diligence having to be shown by defendants (other than the issuer, who is strictly liable). See 15 U.S.C. § 77l. The Stanford Law School Securities Class Action Clearinghouse and Cornerstone Research reports that between eleven and fourteen percent of federal securities class actions filed in recent years arise from section 11. See CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2011 YEAR IN REVIEW, 28 fig. 26 (2012), available at http://securities.stanford.edu/clearinghouse_research/2011_YIR/Cornerstone_Research_Filings_2011_YIR.pdf.

³⁵ See Langevoort & Thompson, *supra* note 13, at 352.

³⁶ Our use of the term "publicness" refers not only to the legal demands of registration under the '33 or '34 Acts but also the public and investor expectations that follow from being publicly traded. See Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137, 141, 143 (2011).

B. The Securities Exchange Act of 1934 and the Move to Integration

At its core, the '34 Act simply extends the disclosure obligations of companies making a public offering in order to protect shareholders trading in those securities. The overlap between the two regulatory regimes is palpable, and for some time it has been understood that they ought to be integrated to the fullest extent possible. In an influential law review article, Milton Cohen observed that the disclosure requirements for American companies would look "quite different" if the securities laws had been enacted in the opposite order or as part of a single, integrated statute.³⁷ Indeed, Cohen's central thesis—that there should be a coordinated disclosure system having as its basis the requirements of the '34 Act—captured the most significant regulatory change of the modern era for securities regulation and has remained the core tenet of American securities regulation for almost fifty years.³⁸

Cohen's vision necessarily contracted the impact of the disclosure required by the '33 Act as more of the disclosure burden was carried by the basic disclosure regime outlined in the '34 Act.³⁹ Incorporating disclosures into an episodic '33 Act prospectus by reference to the recurring '34 Act filings that a company was making on a quarterly and annual basis became a core part of securities filings. Shelf registration further reduced the reach of '33 Act registration because the same disclosure was already available to investors.⁴⁰ Of some importance to what will follow, the '34 Act has been permitted to do more of the work when secondary distributions are made by selling shareholders rather than the issuer itself. Today, in other words, we have something that resembles "company registration," where seasoned issuers that are solidly within the '34 Act system find their special obligations under the '33 Act lightened when additional securities are sold to public investors.

³⁷ Milton H. Cohen, "Truth in Securities" *Revisited*, 79 HARV. L. REV. 1340, 1341 (1966). In the mid-1990s, an SEC advisory committee recommended the formalization of "company registration" in order to streamline the offering and disclosure processes. See U.S. SEC. & EXCH. COMM'N, REPORT OF THE ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES, at ii–iii, 18–19 (1996), available at <http://www.sec.gov/news/studies/capform.htm> (internal quotation marks omitted); John C. Coffee, Jr., *Re-engineering Corporate Disclosure: The Coming Debate over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1146 (1995).

³⁸ See Coffee, *supra* note 37, at 1145.

³⁹ See Cohen, *supra* note 37, at 1379 (stating that given coordinated disclosure with '34 Act requirements, disclosure in a '33 Act context would be limited to "only such special disclosures and related procedures, if any, as are needed for the special protection of offerees as such").

⁴⁰ See Delayed or Continuous Offering and Sale of Securities, Securities Act Release No. 6334, 23 SEC Docket 387 (Aug. 18, 1981) (adopting Rule 415).

The long-recognized challenge of this integrated regulatory system has been that the now seemingly seamless fit of the two acts as to disclosure was not entirely replicated with the other three traditional methodologies of securities regulation, where the '34 Act regime had a lighter regulatory footprint. For sure, the '34 Act also requires SEC staff review of annual reports (and other filings, as needed),⁴¹ but even now such review is not on as predictable a basis as with the public offering. More importantly, this review lacks the leverage the SEC has in the offering context to insist on adherence to its wishes if the issuer wants to launch its offering on the desired timeline.⁴² On the assumption that the issuer itself is no longer selling securities, there is no sales process to regulate through the prophylactics attendant to book-building. Instead, the '34 Act employs a variety of tools to prohibit fraud and manipulation by issuers and others.⁴³ And it builds a comprehensive, multi-layered regulatory regime to address the behavior of the institutional players who make the markets work, the broker-dealer industry, regardless of whether the securities' issuer is public or private.⁴⁴ Importantly, the role of private liability differs dramatically between the two statutes. Although there is a great deal of '34 Act litigation, it is largely fraud-based, requiring a showing of intentionality rather than the strict or due diligence liability found in the '33 Act's express remedies.⁴⁵

Perhaps because of these differences, there has been a long-standing concern that the quality of issuer disclosure diminishes under the '34 Act.⁴⁶ That has produced a three-decade-long effort by Congress and the SEC to create a corporate governance infrastructure inside public companies that compensates for the differences as to SEC review, the role of intermediaries or gatekeepers, and liability.⁴⁷ These take the form of mandatory audit committees, internal control obligations, and a host of other interventions, many of which are the product of the Sarbanes-Oxley Act of 2002, which was a response to scandalous financial misreporting at companies such as Enron and

⁴¹ See Cohen, *supra* note 37, at 1371–72.

⁴² As required by the Sarbanes-Oxley Act, the SEC's Corporation Finance Division undertakes some level of review of the filings of each registrant every three years and a significant number of registrants have their filings reviewed more frequently. See Sarbanes-Oxley Act of 2002 § 104(b), 15 U.S.C. § 7214(b) (2006).

⁴³ See *infra* notes 102–04 and accompanying text.

⁴⁴ See generally 15 U.S.C. § 78o (2006 & Supp. V 2011) (authorizing SEC registration and regulation of brokers and dealers).

⁴⁵ See 17 C.F.R. § 240.10b-5 (2013).

⁴⁶ See Coffee, *supra* note 37, at 1173 n.85; John C. Coffee, Jr. & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707, 755–56 (2009); Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 LAW & CONTEMP. PROBS 45, 46 (2000).

⁴⁷ See Coffee & Sale, *supra* note 46, at 712, 767.

WorldCom.⁴⁸ The accumulation of these '34 Act governance and disclosure obligations have become today's demands of publicness, with intense political controversy over whether this is too much transparency and accountability if we really want to promote robust capital formation. A portion of the JOBS Act that we examine elsewhere—the “on-ramp” for emerging growth companies—suggests that the answer is partially yes.⁴⁹

C. Restating the Law of Public and Private Offerings in an Integrated Securities Regulation System

This extremely simplified description of the two main securities laws is enough to set the foundation for what we will explore in the remainder of this Article. The '34 Act provides an information-forcing regime to protect investors in the trading market with a variety of external due diligence mechanisms to bolster disclosures made by an issuer.⁵⁰ The '33 Act focuses on additional protection thought necessary when there are special selling efforts, an idea about which we will have more to say shortly.⁵¹ In each regime, publicness obligations are removed or reduced based on various exemptions. For example, the requirements for registered public offerings under the '33 Act do not apply to private placements, described in the seminal Supreme Court decision *SEC v. Ralston Purina Co.* as offerings made to those who, because of some combination of presumed sophistication and access to information, can “fend for themselves.”⁵² Under Rule 506 of Regulation D (Reg D),⁵³ which purports to be an interpretation of the *Ralston Purina* standard but in fact marks a fairly radical departure in terms of practice, an issuer can sell stock without registering it under the '33 Act to any number of “accredited investor[s],” a category which today includes individuals with upper-middle-class income or a net worth over one million dollars.⁵⁴ Such investors do not actually have to be sophisticated, do not have to have a relationship with the

⁴⁸ See Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1(m) (2006).

⁴⁹ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 101-108, 126 Stat. 306, 307-13 (2012) (to be codified in scattered sections of 15 U.S.C.); Langevoort & Thompson, *supra* note 13, at 371.

⁵⁰ See Coffee, *supra* note 37, at 1157; Langevoort, *supra* note 46, at 58-59.

⁵¹ See Cohen, *supra* note 37, at 1385-86 (“A different sort of pragmatic answer is that ‘selling’ plays a greater role in typical public offerings than in trading transactions, and a prescribed prospectus is the best means of assuring truth in sales literature. . . . Moreover, the issuer (and, by extension, the affiliate) is here wearing two hats, as a seller of securities and as the main source of relevant disclosures, so that there may be special temptations to favor the selling role at the expense of the disclosing one.”).

⁵² 346 U.S. 119, 125 (1953).

⁵³ 17 C.F.R. § 230.506 (2013).

⁵⁴ See 17 C.F.R. § 230.501(a)(5) (2012) (defining accredited investor to include “[a]ny natural person” whose net worth, combined with a spouse’s but exclusive of home equity, exceeds one million dollars).

issuer, and do not have to receive any disclosure from the issuer.⁵⁵ The result was to push back the line of a public offering and permit more sales (and resales) to occur without the core regulatory protections of the '33 Act or the '34 Act. Such changes reflected the deregulatory era and greater trust in markets that took hold in the early 1980s and thereafter, and there was a sense that the self-cleansing nature of markets would permit a lighter regulatory touch.⁵⁶ We come back to this in Part III to consider what the JOBS Act has done with respect to Reg D offerings to accredited investors.⁵⁷

Other exemptions come with more strings attached. This takes us back to Cohen, who also sought to change the approach to conceptualizing the boundary of '33 Act regulation.⁵⁸ He advocated for moving beyond the historical "all or nothing" approach of '33 Act coverage by implementing a middle category of regulation that tied the disclosure requirements to the size of the offering.⁵⁹ When the Reg D exemptions from '33 Act registration were promulgated in the early 1980s, for example, companies raising smaller amounts of money from nonaccredited investors faced lighter regulatory burdens, but still significant obligations, in order to gain exempt status.⁶⁰ This was true of Regulation A (Reg A) as well, which created a simplified registration system through which small offerings could be made (also expanded significantly in the JOBS Act).⁶¹

The '34 Act traditionally has used different metrics for determining what companies have disclosure obligations, focusing on the company's size as measured by its number of shareholders and assets rather than the qualitative investor characteristics or the scaled approach to regulation seen in the '33 Act space; those measures of actively traded securities defined the companies that would have to meet the main disclosure requirements of the securities laws.⁶² The JOBS Act enacts a remarkable transformation in moving the two acts closer together in terms of their approach to boundaries. It inserts the investor qualification approach from the '33 Act into the '34 Act by making

⁵⁵ See 17 C.F.R. §§ 230.502(b)(1)–(b)(2)(i), .506(b)(2)(i)–(ii) (2012).

⁵⁶ See Coffee & Sale, *supra* note 46, at 714.

⁵⁷ Regulation A, authorizing a mini-registration, was first adopted in 1936. See Securities Act Release Nos. 627–32, 1936 WL 30895 to 30900 (Jan. 21, 1936). See *infra* notes 164–67 for a discussion of the new Regulation "A+" authorized by the JOBS Act.

⁵⁸ See Cohen *supra* note 37, at 1349.

⁵⁹ *Id.* His approach was to be "entirely apart from the disclosure system of the 1934 Act." *Id.* at 1350.

⁶⁰ See Securities Act Release No. 6389, 47 Fed. Reg. 11,251, 11,252 (Mar. 16, 1982) (adopting Reg D); Securities Act Release No. 6339, 46 Fed. Reg. 41,791, 41,795 (Aug. 18, 1981) (proposing Reg D).

⁶¹ See Securities Act Release Nos. 627–32, 1936 WL 30895 to 30900 (Jan. 21, 1936).

⁶² See Cohen, *supra* note 37, at 1367–68 (describing the '34 Act as implementing a "continuous disclosure system . . . designed for the benefit of investors and potential investors in all securities in which there is an active, continuous market interest").

it possible for companies to avoid reporting-company obligations measured not just by the number of investors who may be trading the stock but also by whether they are accredited investors.⁶³ And the on-ramp provisions of the JOBS Act illustrate a massive scaling of '34 Act obligations for emerging growth companies that expands on the sort of scaling long used in the '33 Act.⁶⁴

We focus here on the '33 Act exemptions as expanded after the JOBS Act and on the transitional territory at the boundary of the '33 and '34 Acts. Our methodology is fairly straightforward. For each of these settings, we ask about each of the four features of securities regulation described earlier: disclosure content, SEC review, restrictions on sales pressure, and liability, especially with respect to the ability to force due diligence. Where one or more of these features is compromised or abandoned to facilitate some kind of transaction, we ask, why? Are we comfortable with what compensates for the loss (whether it comes through conditions attached to an exemption or the hoped-for presence of '34 Act regulation)? These may seem like obvious questions to ask, but as we noted earlier, so many innovations in securities law emerge haphazardly, with occupations of newly created space only getting sustained, formal SEC attention later on and even then only incrementally. If so, these kinds of questions are never asked and answered systematically.

We also need to ask a more fundamental question about the interplay between the '33 and '34 Acts that will be key to all that follows: Once we assume the basic information-forcing presence of the '34 Act to help buyers or sellers of securities in ordinary trading transactions, why should we add the heavy additional regulation associated with the '33 Act? The self-interest of the issuer in the success of its capital raise, which tempts it to cheat, provides a starting point, but we doubt that self-interest alone suffices as an explanation. After all, there are temptations to cheat on the part of managers in the form of stock options as well as other incentives that are strong even when the issuer is not selling any stock. Our sense is that there is something to be gained by looking at the opposite side of the coin. Where sales by an issuer, underwriters, or affiliates could be absorbed by buyers without any special soliciting efforts, we doubt there would be the need for heavy-handed regulation stemming from the temptation alone—perhaps no more than a public announcement that the issuer is selling coupled with the mandatory disclosure that the '34 Act demands. What makes a public offering special in terms of investor protection is the business-driven need to induce increased demand so as to absorb

⁶³ See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012) (amending 15 U.S.C. § 78l(g)(1)(A)).

⁶⁴ See Jumpstart Our Business Startups Act §§ 101–108.

a large number of shares suddenly coming to market—work typically done by financial intermediaries (underwriters and dealers). It is the combination of that need and the issuer's self-interest that justifies the registration requirement.

We can see this idea in section 4(a)(4) of the '33 Act, exempting ordinary trading transactions from registration.⁶⁵ It is also apparent in Rule 144's "dribble out" process, which limits sales by control persons to finite batches without any unusual sales efforts⁶⁶ and about which we have more to say later on. Were we to restate the law of public versus private offerings, we would say that the '33 Act is about regulating issuer or affiliate sales that are likely to result in a "dump" that will require special soliciting efforts, with the potential for abuse that entails.⁶⁷ And if that is right, then we will need to pay special attention to the third and fourth features of the '33 Act: sales-practice regulation and liability. The first of these is self-evident, the second more subtle. Of course antifraud liability addresses the most obvious forms of cheating in the offering process. But to the extent that liability under the '33 Act forces external due diligence, the selling process is affected as well. If lawyers representing directors, placement agents, and brokers feel pressure to dig more deeply into issuer quality, innocent, careless, or willfully blind misrepresentation by salespeople presumably becomes less likely.

Our impression is that this is what is most easily lost in the hybrid settings that we are about to explore. For example, trading markets can be created via reverse merger without the due diligence that a '33 Act rite of passage entails and in the absence of '34 Act protections that provide equivalent diligence. Public companies squeeze their capital-raising transactions somewhat awkwardly into an ostensibly '34 Act setting to reduce liability (and the due diligence that will follow from that). With the integration of the two Acts, more transactions are covered by the '34 Act, and more importantly, there are more spaces for special selling efforts with the less intense '34 Act regulation. To us, this is especially interesting territory, and we examine it in Part II. There are more similarities to these hybrid settings than first meet the eye, which help us theorize about the borders separating the two acts.

Part III is where we turn to the new world of private placements after the JOBS Act, in which far more aggressive advertising and mar-

⁶⁵ See 15 U.S.C. § 77d(4) (2006 & Supp. V 2011).

⁶⁶ See JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 362–72 (6th ed. 2009).

⁶⁷ See Comm. on Fed. Regulation of Sec., ABA Section of Bus. Law, *Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors—A Report*, 66 BUS. L. 85, 86 (2010). Our point is not to take anything as given and instead to ask why we should have something more than '34 Act-style company registration.

keting is permitted under the '33 Act as issuers and their agents prospect for accredited investors without the due diligence requirements that exist elsewhere in the '33 Act space. In contrast to reverse mergers or PIPEs, this occurs without any regulatory oversight at all. And after the Supreme Court's unexpected decision in *Gustafson v. Alloyd Co.* in 1995, the diligence-forcing liability prong of securities regulation has been withdrawn as to these issuances because the Court limited section 12(a)(2)'s negligence-based policing of misstatements and omissions in selling material to transactions characterized as public offerings (though not necessarily registered ones).⁶⁸ Truly private offerings become "fraud-only," so that there is less incentive for any serious rite of passage. Publicness obligations are put off into the future, arising only if and when the issuer separately triggers one of the '34 Act definitions for public company status. And as noted, entering into the '34 Act space is not quite the same as the '33 Act rite of passage. The Supreme Court's opinion has been heavily criticized by many academics.⁶⁹ There have been efforts to reverse *Gustafson* through legislation, thus far unsuccessful.⁷⁰ By illustrating its effect in three settings that are significant for transactions, part of our account here is meant to support a continuation of that effort, which becomes all the more important as technology creates more and more "private" capital-raising opportunities that look like de facto public offerings.

In all of this, we acknowledge that we have largely assumed—not demonstrated—that '33 Act interventions like registration, disclosure, due diligence, and liability generate significant benefits for investors, benefits that exceed their costs.⁷¹ As we stated at the outset, our effort here is to remap the boundaries of the '33 Act in light of what has changed recently and not to ask, even though it is a perfectly legitimate question, whether the '33 Act works well as applied to the baseline offerings, IPOs. Our sense is that the statutory foundation—

⁶⁸ 513 U.S. 561, 581–82 (1995). There are, however, FINRA obligations regarding diligence in private placements. See *infra* notes 199, 234.

⁶⁹ Edmund Kitch calls it an opinion that does "not write," lacking in any logical progression of thought. See Edmund W. Kitch, *Gustafson v. Alloyd Co.: An Opinion that Did Not Write*, 1995 SUP. CT. REV. 99, 99.

⁷⁰ See, e.g., 156 Cong. Rec. S3566 (daily ed. May 11, 2010) (statement of Sen. Carl Levin), 2010 WL 1873206.

⁷¹ This was the challenge to the '33 Act of the first generation of law and economics scholars. E.g., George J. Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117, 124 (1964). For a more contemporary discussion, see Luigi Zingales, *The Future of Securities Regulation*, 47 J. ACCT. RES. 391, 392 (2009). Adam Pritchard, responding in part to an earlier version of our paper, suggests the abolition of the IPO in favor of a model that forces new entrants to the public market to become seasoned in a private trading market for a period of time. See Adam C. Pritchard, *Facebook, the JOBS Act, and Abolishing IPOs*, REGULATION, Fall 2012, at 17. And in helpful comments on this article, Anna Pinedo observed that the registered IPO is currently under transformation toward more "private-ness," the mirror image of what we are discussing here.

though surely in need of some updating—is fundamentally sound, and we could point to plenty of indirect evidence in that direction but leave to the side this largely empirical question.⁷² So, too, will we leave largely unaddressed what some deeply conservative critics of governmental regulation say: that it is illegitimate to spend public resources to protect competent adults from their own foolish economic choices, especially if the burdens fall on potentially productive economic activity.⁷³ We are quite sure that some of the push for the JOBS Act reflects that ideology, more than just the instrumental pursuit of capital formation or job creation, and that securities regulation will be struggling with this ideological battle for some time to come.

II HYBRID TRANSACTIONS

The integration of the '33 and '34 Act regulatory systems over the last half century created opportunities for issuers to structure transactions that skip the usual rite of passage of a registered public offering under the '33 Act, arbitraging the differences in regulation under the two Acts. This Part discusses two examples of current interest where we think a better understanding of the theory underlying the line between public and private in securities regulation obligations—particularly the emphasis on sales pressure—would help formulate a sensible policy.

A. Reverse Mergers

“Shell games” have plagued securities regulation for half a century. Using an issuer with little or no assets or operations as a back-

⁷² For a recent survey of the evidence favoring regulation, see Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 337 (2006). For a discussion of regulation predating the U.S. experience and with useful literature citations, see Carsten Burhop et al., *Regulating IPOs: Evidence from Going Public in London and Berlin, 1900–1913*, 3 (2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1884190.

⁷³ We regard this as the somewhat easier response: Even putting aside the felt need to protect some investors who might be particularly vulnerable, efficient regulation enhances the likelihood of investment (and hence capital formation) as compared to a world in which rational investors are left to their own resources to separate the good fruit from the lemons. That is often too costly and would thus lead to systematic underinvestment. See, e.g., *Examining Investor Risks in Capital Raising: Hearing Before the Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. (2011) (statement of John C. Coates IV, Professor of Law and Economics, Harvard Law School). Instrumentalist conservatives immersed in the field tend to accept the desirability in theory of some regulation on these grounds even though they doubt the ability of the government to deliver efficient solutions. E.g., Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1048 (1995). On how well the history of the '33 Act's origins fits with all this, see Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1, 30–31 (2001).

door mechanism by which a private (largely unknown) issuer becomes publicly tradable has tempted issuers and promoters as a way of bypassing the '33 Act registration process. In the early days, spin-offs (i.e., in-kind distributions of securities to an existing shareholder base) were the chosen route;⁷⁴ more recently, the reverse merger has been the preferred vehicle.⁷⁵ The frequency with which Chinese companies have used the reverse-merger process to enter U.S. markets has gained headlines along with concerns—and regulatory enforcement—about risks to investors.⁷⁶ Even putting aside this global-reach phenomenon, reverse mergers have become a common transaction, rivaling if not exceeding the number of registered public offerings in a given year.⁷⁷

Reverse mergers can take a number of forms, but all share the same theme⁷⁸: a private company directly or indirectly merges into a shell company that has established itself as a public issuer under the '34 Act.⁷⁹ The shell may have been incubated for this purpose, or it may be the ghost of a once-active public company that has ceased operations but still has shares outstanding. Once this transaction is complete, the shell provides the legal identity for the private company;

⁷⁴ See COX ET AL., *supra* note 66, at 399–404. The term “reverse merger” refers to a larger number of transactions than simply those involving shells. For example, there have been many instances where the private issuer merges into a smaller (but active) public company in order to take on its public status, perhaps (but not necessarily) later spinning off those activities so that the surviving company is identical to the formerly private company. For a study that focuses on this broader array of reverse mergers, see Kimberly C. Gleason et al., *Alternatives for Going Public: Evidence from Reverse Takeovers, Self-Underwritten IPOs, and Traditional IPOs*, FIN. DECISIONS 2 (Summer 2008), <http://www.financialdecisionsonline.org/current/GleasonJainRosenthal.pdf>. Famously, the NYSE went public by acquiring a smaller but publicly traded trading platform, Archipelago. See Stephen Taub, *NYSE Goes Public, Goes Electronic*, CFO.COM (April 21, 2005), <http://www.cfo.com/article.cfm/3903963?f=related> (describing the deal as a reverse merger where the NYSE shed its not for profit form).

⁷⁵ On the mechanics of reverse mergers, see generally DAVID N. FELDMAN, *REVERSE MERGERS AND OTHER ALTERNATIVES TO TRADITIONAL IPOs* (2d ed. 2009); Sjöström, *Truth About Reverse Mergers*, *supra* note 21, at 743–44.

⁷⁶ E.g., David Barboza & Azam Ahmed, *A Thorn for Chinese Companies*, N.Y. TIMES, June 10, 2011, at B5; Nanette Byrnes & Lynnley Browning, *China's Shortcut to Wall Street*, REUTERS, Aug. 1, 2011, available at <http://www.reuters.com/article/2011/08/01/us-shell-china-idUSTRE7702S520110801> (stating that since 2002, more than four hundred private Chinese companies used reverse mergers with U.S. shells and noting that, through July 2011, the cumulative loss in market capitalization among these companies exceeded eighteen billion dollars). There is some research, on the other hand, suggesting that these losses are not out of line with reverse-merger risks generally. See Charles M.C. Lee et al., *Shell Games: Are Chinese Reverse Merger Firms Inherently Toxic?* 5–6 (Nov. 6, 2012) (unpublished manuscript), available at <https://ssrn.com/abstract=2155425>.

⁷⁷ See Cécile Carpentier et al., *The Value of Capital Market Regulation: IPOs Versus Reverse Mergers*, 9 J. EMPIRICAL LEGAL STUD. 56, 57 (2012) (noting that from 2004–2008 there were 1065 reverse mergers in the U.S. compared to 672 registered IPOs).

⁷⁸ See SEC Investor Bulletin: *Reverse Mergers*, U.S. SEC. & EXCH. COMM'N (June 9, 2011), <http://www.sec.gov/investor/alerts/reversemergers.pdf>.

⁷⁹ See, e.g., Carpentier et al., *supra* note 77, at 60–61.

this means that the private company stands in the shoes of the public company so far as both the trading market and financial reporting obligations are concerned. The private company has thus become public, bringing a newfound liquidity for investors once any resale restrictions lapse, without any change in control.⁸⁰

While these transactions are sometimes promoted as ways of “going public” without ’33 Act registration burdens, there is an obvious difference: in a reverse merger, the private company does not raise any capital in the process⁸¹ but instead suffers significant shareholder dilution in terms of the value transferred to the shell and its promoter for their services (plus other costs and expenses). However, the reverse merger may set the stage (though by no means necessarily) for a subsequent round of simplified public financing—typically in the form of a PIPE transaction, which is available only to ’34 Act registrants⁸² and to which we turn next.

The economics of reverse mergers are worth pondering. At first glance, reverse mergers with empty shells seem nonsensical—sham transactions designed simply to avoid regulation.⁸³ But a handful of studies of reverse mergers show that the shell marketplace is populated by some promoters who are repeat players and raise capital from specialized shell investors who demand (and receive) significant returns in the face of high risk.⁸⁴ Arguably, the most successful shell

⁸⁰ A variation on this is the “special purpose acquisition corporation” (SPAC), which is a shell company that raises funds in a registered public offering and then seeks out another company to acquire through a reverse merger. The economics of this arrangement are quite different from the kinds of reverse mergers we are focusing on because transactions involving SPACs anticipate a control shift to the SPAC shareholders. In essence, they are private-equity-type arrangements with public trading. A recent study of SPACs calls them “reverse mergers ‘done right.’” See Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 849, 878 (2013); see also Steven M. Davidoff, *Black Market Capital*, 2008 COLUM. BUS. L. REV. 172, 224–28 (discussing SPACs and calling them “a species of private equity”). The differences are such that they deserve distinct treatment, which is outside the scope of our Article, but we note that there is a potential for regulatory arbitrage parallel to what we have been discussing. In the SPAC transaction, the core information for investors will be disclosed in the proxy disclosure attendant to the shareholder vote rather than in the registered public offering when the funds are initially raised. The result is less intense ’34 Act disclosure, due diligence, and liability for the deal.

⁸¹ See Sjoström, *Truth About Reverse Mergers*, *supra* note 21, at 757–59.

⁸² PIPE financing follows a significant percentage of reverse mergers. See Jeff Joseph, *IPO Alternatives: Reverse Mergers*, ADVISORONE (May 1, 2008), <http://www.advisorone.com/2008/05/01/ipo-alternatives-reverse-mergers>. The newly public company can also make acquisitions, using the public shares as currency.

⁸³ For a fairly critical perspective along these lines, see 3A HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES AND FEDERAL CORPORATE LAW* § 6.69 (2012).

⁸⁴ See Ioannis V. Floros & Kuldeep Shastri, *A Comparison of Penny Stock Initial Public Offerings and Reverse Mergers as Alternative Mechanisms for Going Public* 31–32 (Aug. 24, 2009) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1460979.

promoters will be those skilled at identifying emerging companies that, in the face of considerable informational asymmetry, have potential, even if success is a long shot.⁸⁵ Much like investment bankers or venture capitalists, they act as reputational intermediaries, with the same (imperfect) constraints on opportunism as a result.⁸⁶

But nothing limits the reverse merger market to this high-end segment, and on the more troubling side we have the concerns of both problematic disclosure and sales pressure.⁸⁷ The liquidity demands that the existing private-company shareholders—particularly controlling shareholders—bring to the transaction are coupled with the likely desire of the shell promoter and associates to exit as soon as possible.⁸⁸ This may call for aggressive sales practices, perhaps of the boiler room variety, designed to pump up the price of the securities by stimulating enough demand to absorb the large impending dump. It is likely that a sample of reverse mergers at any given time will fall along a continuum whereby the better reverse-merger candidates utilize intermediaries who can signal the legitimacy of the deal, while lesser candidates are left to the less savory reputational end of the marketplace.

Therein we find a fascinating regulatory challenge. What empirical evidence there is suggests that reverse mergers are highly risky—one study suggests that some forty-two percent of reverse merger companies were delisted within three years⁸⁹—and that retail investors do not distinguish as well as they should when faced with reverse mergers. In a Canadian study, the average returns on a portfolio of reverse-merger securities were significantly less than on a basket of IPO-registered securities, indicating that investors do not sufficiently adjust the price they are willing to pay to reflect the increased risk.⁹⁰ By contrast, the U.S. approach tolerates backdoor registration but with en-

⁸⁵ See Ioannis V. Floros & Travis R.A. Sapp, *Shell Games: On the Value of Shell Companies*, 17 J. CORP. FIN. 850, 865–66 (2011).

⁸⁶ See *id.* at 866.

⁸⁷ See Bill Alpert & Leslie P. Norton, *Beware this Chinese Export*, BARRON'S, Aug. 30, 2010, at 21 (discussing how Chinese companies circumventing the IPO process “fall between the cracks of market regulation”). Proponents of reverse mergers concede this “bad guy” phenomenon but emphasize that nearly all deal structures can be abused, especially when there is inadequate policing. See FELDMAN, *supra* note 75, at 107–21; David Feldman, *Chairman Schapiro: Please Don't Decimate Small Company Finance*, REVERSE MERGER & SPAC BLOG (July 3, 2011, 9:56 AM), www.reversemergerblog.com/2011/07/03.

⁸⁸ See Floros & Sapp, *supra* note 85, at 851.

⁸⁹ See Frederick Adjei et al., *The Determinants and Survival of Reverse Mergers vs IPOs*, 32 J. ECON. & FIN. 176, 189 (2008).

⁹⁰ See Cécile Carpentier & Jean-Marc Suret, *Entrepreneurial Equity Financing and Securities Regulation: An Empirical Analysis*, 30 INT'L SMALL BUS. J. 41, 55 (2012); see also Carpentier et al., *supra* note 77, at 58 (noting that investors “involved in IPOs and [reverse mergers] do not exhibit the characteristics of rational behavior in the classical mean-variance scheme”).

hanced regulatory protections. There are probably many reasons for this, including the legal metaphysics of assessing whether the issuer or its affiliates are disposing of securities “for value” in the course of the transaction, a statutory trigger for the ’33 Act registration requirement.⁹¹ But case law from the early days of shells and spin-offs suggests a liberal reading of the value requirement that does not insist on paid-in consideration.⁹² The SEC probably could do more to clamp down on this market if it wanted. Its uneasy tolerance no doubt reflects a mix of political pressure—the reverse-merger market is lucrative and has some strong proponents—and some intuition that there are benefits to leaving the back door ajar.

It is this last point that we want to think about here because if it is true, it says something important about the current regulatory structure at the intersection of the ’33 and ’34 Acts. Describing the current regulatory philosophy toward reverse mergers (which is currently being rethought yet again in light of the problems with Chinese companies⁹³) is difficult—there are a large number of unanswered questions lurking due to the doctrinal complications mentioned above. By and large, the SEC has been willing to let the ’34 Act do the work for reverse mergers without the additional discipline provided by the ’33 Act rite of passage. In 2005, the SEC revised its Form 8-K requirements (imposing “current” reporting obligations in advance of 10-Qs or 10-Ks) to describe the material terms of the transaction and transform the inert public shell into a completely new, active issuer, along with financial statements and pro forma financial information with respect to the newly combined entities.⁹⁴ Other rules scattered throughout the ’33 and ’34 Acts put additional speed bumps into place where shell-company transactions are involved.⁹⁵ By most accounts, the reverse-merger environment improved as a result.

Yet, there are important differences in reverse-merger companies from other issuers who come under the ’34 Act. For example, there is no negotiation as to the disclosure with the SEC at the time of the transaction and it is unclear how many reverse-merger companies really get a serious “gatekeeper” checkup.⁹⁶ From an accounting stand-

⁹¹ See 15 U.S.C. § 77b(a)(3) (2006 & Supp. V 2011) (defining the sale of securities to include “sale or disposition . . . for value”).

⁹² See *SEC v. Datronics Eng’rs, Inc.*, 490 F.2d 250, 253–54 (4th Cir. 1973).

⁹³ See Aguilar, *supra* note 19.

⁹⁴ See SEC, FORM 8-K, items 2.01(f), 5.01(a)(8), available at <http://www.sec.gov/about/forms/form8-k.pdf>; 3A BLOOMENTHAL & WOLFF, *supra* note 83, at §§ 6:70–6:71.

⁹⁵ See, e.g., SEC Rule 144(i)(1)(i), 17 C.F.R. § 230.144(i)(1)(i) (2013) (disqualification for a “business combination related shell company”); SIMON M. LORNE & JOY MARLENE BRYAN, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 3:11.15 (2012).

⁹⁶ The SEC indicated that it was stepping up its review, at least as to Chinese reverse-merger companies. It has also approved new exchange listing requirements limit-

point, this has been a principal concern of the SEC with respect to some of the Chinese reverse mergers, where audits that satisfy the basics of independent oversight have not occurred. But that particular worry exists because of the extraterritorial nature of the transaction and the global outsourcing of the audit work.⁹⁷

More profoundly, what '33 Act registration adds to this rite of passage is discipline, both *ex ante* and *ex post*. Among the gatekeepers in nearly all registered IPOs are the underwriters, who have their own lawyers. The underwriters take on responsibility for selling the securities and have powerful (if not lock-tight) reputational incentives not to take a company public if it will be exposed as a fraud in the not too distant future.⁹⁸ And this incentive, of course, is reinforced by section 11, which creates liability on the part of underwriters to purchasers for any failures of due diligence in the preparation of the required disclosures in the registration statement.⁹⁹ Similar liability faces the board of directors, nondirector signatories of the registration statement, and the auditors; the issuer itself faces strict liability for any material misstatements or omissions.¹⁰⁰ The result is fairly thorough diligence in investigating the truth behind the issuer's representations.

The '34 Act environment is different. At the federal level, private liability is *scienter* based, a much more difficult showing for plaintiffs.¹⁰¹ To be sure, the SEC has a variety of enforcement tools that can be put to work for disclosure failures in the reverse-merger setting, even without a showing of deliberate misconduct on the part of the issuer or the promoters, and so do FINRA and securities exchanges on which reverse merger shares might be traded.¹⁰² Broker-dealers may not recommend any security to a customer unless they have come to "know" the security through at least minimal (albeit

ing the accessibility of reverse-merger firms. See Press Release, Sec. & Exch. Comm'n, SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Companies (Nov. 9, 2011), <http://www.sec.gov/news/press/2011/2011-235.htm> (describing SEC approval of rules for listing markets that toughened standards for firms to be listed via reverse mergers).

⁹⁷ See PUB. CO. ACCOUNTING OVERSIGHT BD., ACTIVITY SUMMARY AND AUDIT IMPLICATIONS FOR REVERSE MERGERS INVOLVING COMPANIES FROM THE CHINA REGION: JANUARY 1, 2007 THROUGH MARCH 31, 2010, at 7–8 (2011), available at http://pcaobus.org/research/documents/chinese_reverse_merger_research_note.pdf.

⁹⁸ See COX ET AL., *supra* note 66, at 116–35 (describing the role of underwriters).

⁹⁹ See 15 U.S.C. § 77k (2006).

¹⁰⁰ See *id.*

¹⁰¹ See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (requiring *scienter* for a 10b-5 action); 17 C.F.R. § 240.10b-5 (2013).

¹⁰² See FINRA RULE 2310(b)(3), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=8469 (requiring reasonable grounds to believe that all material facts are adequately and accurately disclosed).

maybe fairly superficial) diligence.¹⁰³ All these rules could produce some degree of due diligence, but it is not clear that they do so consistently enough. Given that action is highly unlikely with respect to relatively small-scale distributions that are not directly in the regulators' line of sight, discipline can easily become lax. At the low end of the spectrum, where reputational incentives are already weak, discipline can be nonexistent. This is one place that *Gustafson* had a particularly distressing effect.¹⁰⁴

So what would an optimal reverse merger policy be? We should start with the obvious: the reverse merger is just a form of regulatory arbitrage. No economic value is added by the artificial process of combining with a public shell that may not be readily accomplished by more direct means—it is just that the regulatory burdens are reduced because of shell formalism. To the extent that reverse mergers are a gateway to the simplified financing available only to public companies, voluntary-filer status serves the same purpose. To the extent that the reverse merger is a way of quickly pushing out securities to create more liquidity for trading in the issuer's stock, this is ordinarily done under much more controlled circumstances—a registered public offering, or a Reg D or Reg A transaction. The question is really whether the SEC ought to create an exemption for large-scale secondary sales of issuer securities promptly upon gaining '34 Act public-company status.

We suspect that the answer is yes but with conditions relating to both timing and volume—a Rule 144-style solution.¹⁰⁵ Indeed, we think that the proper policy as to what constitutes a public offering is better gleaned not so much from *Ralston Purina* and its long and tortured legacy but from the intricate law and lore on the meaning of “underwriter.” Students new to securities regulation struggle—albeit profitably—with what it means for an intermediary to buy from an issuer or affiliate with a view toward a distribution.¹⁰⁶ So what is a distribution? The case law references *Ralston*—and that does become the gateway to Rule 144A and “4(1½)” transactions—but SEC policy has a somewhat different emphasis as it plays out in Rule 144.¹⁰⁷ Resales can take place either by limiting the amount and sales pressure

¹⁰³ See COX ET AL., *supra* note 66, at 1031–36 (discussing the duty of a broker-dealer to conduct independent analysis on recommended securities).

¹⁰⁴ See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 570–71 (1995) (holding that section 12 liability does not apply to private, secondary transactions).

¹⁰⁵ See 17 C.F.R. § 230.144 (2013) (providing safe harbor for resale of restricted securities based on holding period and for resales on behalf of affiliates based on limited number of shares sold if done only in a broker's transaction).

¹⁰⁶ See COX ET AL., *supra* note 66, at 345–62 (discussing the inclusion of anyone who “purchased from an issuer with a view to . . . [a] distribution” in the statutory definition of an “underwriter” and its effect on the purchaser (internal quotation marks omitted)).

¹⁰⁷ See *id.* (discussing the adoption of Rule 144 and its relationship with the case law).

associated with the resales and insisting on a relatively fresh informational environment (in the case of transactions by the issuer's control persons), or by implementing a long-enough holding period (in the case of transactions by others who have bought from the issuer without '33 Act registration).¹⁰⁸ The holding period in the latter context was reset after the 2007 amendments to the rule: generally, the period became one year for securities of private companies and six months for public companies.¹⁰⁹ Importantly, Rule 144(i) creates stricter rules for resales of restricted securities in the aftermath of a shell company transaction like a reverse merger by generally setting the holding period at one year, in effect treating these resales as if they were made for shares in a company that was not a '34 Act reporting company.¹¹⁰

There are three questions here; one conceptual, another legal, and the last empirical. First, one of the great and largely unremarked-upon (at least by academics) developments in '33 Act theory has been the step-by-step shortening of the Rule 144 holding period. Initially, it was three years for nonaffiliates or two for affiliates.¹¹¹ For some time, resellers could "dribble out" the securities under controlled conditions.¹¹² After a quarter century went by, it was reduced to two or one years, respectively.¹¹³ In 2007, it became one year or six months.¹¹⁴

This is not just technical. The conceptual question posed is this: Assume an issuer wants to raise a significant amount of capital. One alternative is a registered public offering, with the attendant costs and burdens. Another is a Rule 144A deal that stays within the closed Qualified Institutional Buyer (QIB) network.¹¹⁵ A third is a private placement to accredited investors (e.g., hedge funds) with the expectation that these securities will be sold freely—maybe aggressively—as soon as the Rule 144 holding period expires. Obviously, a period of two or three years is a lengthy time for the securities to be at rest; six

¹⁰⁸ See 17 C.F.R. § 230.144 (providing a safe harbor for those who might be considered underwriters because they sell for an issuer or control person in connection with a distribution).

¹⁰⁹ See COX ET AL., *supra* note 66, at 363–68 (discussing the 2007 amendments); see also *infra* note 194 and accompanying text (noting changes to the holding period).

¹¹⁰ See 17 C.F.R. § 230.144(i).

¹¹¹ See Notice of Adoption of Rule 144, Securities Act Release No. 5223, 1972 WL 121583 at *16 (Jan. 11, 1972) (adopting Rule 144 with holding periods reflecting prior case law).

¹¹² See 17 C.F.R. § 230.144(e), (g), (h) (1973). The rule permits sales of the greater of the average weekly volume of shares traded or one percent of the outstanding stock if sold in a broker's transaction only.

¹¹³ See Revision of Holding Period Requirements, Securities Act Release No. 7390, 63 SEC Docket 2078 (Feb. 20, 1997).

¹¹⁴ See Revisions to Rules 144 and 145, Securities Act Release No. 8869, 92 SEC Docket 110 (Dec. 6, 2007).

¹¹⁵ See COX ET AL., *supra* note 66, at 374–80 (discussing Rule 144A's safe harbor and its QIB restriction). QIBs are financial institutions with more than one hundred million dollars under management. 17 C.F.R. § 230.144A(a)(1)(i) (2013).

months or a year, not so much. One has to ask if we are not close to, if not at, a point at which it will be seriously tempting for intermediaries to take on that limited holding period (perhaps with some hedging of the risk) if there are no limits or restrictions—other than antifraud rules—on the dump that takes place thereafter. If so, that could be one more nail in the coffin of the registered public offering and the demise of the protections supposedly afforded by the '33 Act.

In particular, what is now missing with respect to nonaffiliate transactions is the dribble out which provides a period during which only limited amounts of securities could be resold and only through brokers prohibited from using any special solicitation efforts.¹¹⁶ This allows for the gradual absorption of the stock before the holding period runs out entirely and a check on overly aggressive sales practices.

The legal question relates to who, among those involved in the reverse merger, has to lock up their shares for whatever period of time Rule 144 specifies? Because the shell's acquisition of the private company is typically done pursuant to a private placement exemption, the new shares held by the private company's former shareholders are restricted and thus not immediately resalable.¹¹⁷ As to other participants, the law is more complicated. The SEC has been relatively successful in court in holding shell promoters as underwriters when they try to dump too quickly,¹¹⁸ but compliance in this area is questionable.¹¹⁹

That leads to the empirical question: What kind of aggressive selling does take place immediately after a reverse merger, and by whom? We are not aware of good data on this question and so can only speculate and refer to anecdotal evidence. One possibility is that the red flags of underwriter status are often ignored in this under-policed neighborhood, and those close to the transaction are causing rapid selling to occur notwithstanding the section 5 risks. Another is that the selling efforts shift to the periphery, with the pumping done by technically unaffiliated parties who nonetheless may be acting in concert with shadier shell promoters on some kind of quid pro quo basis.

Clarity alone is unlikely to be enough to stem the kind of sales pressure that is likely to build up in lower-quality offerings. Again, we

¹¹⁶ 17 C.F.R. § 230.144(e) (2012) (applying volume limitations only in the case of affiliates).

¹¹⁷ See Sjostrom, *Truth About Reverse Mergers*, *supra* note 21, at 747–48 (describing the resulting Rule 506 shares of a typical reverse merger as restricted securities).

¹¹⁸ See, e.g., *SEC v. M&A West Inc.*, 538 F.3d 1043, 1051 (9th Cir. 2008) (refusing to allow tacking); *SEC v. Cavanagh*, 445 F.3d 105, 106 (2d Cir. 2006) (describing resale of control person securities).

¹¹⁹ See Sjostrom, *Truth About Reverse Mergers*, *supra* note 21, at 746–47 (describing a typical reverse merger).

are dealing with a fairly opaque, retail-oriented marketplace that is likely to break into segments that include large numbers of unsophisticated investors. That quality can be signaled to some investors does not mean that lemons cannot be sold to others. The question to ask is whether some of the practices associated with '33 Act registration can be imported into this setting while keeping in mind that this is not an issuer capital-raising transaction and should not be regulated as such.

We would suggest a "Form RM" to be filed by the public shell in advance of the completion of a reverse merger. Again, there is no significant economic value in a reverse merger with a shell company except to the extent that the shell operates as a signaling device, which it cannot do unless it has come to know its merger partner fairly thoroughly. We will take it as true that high-quality, reverse-merger transactions have substantial due diligence built into the timetable. If so, it makes sense to require the shell and its promoter to represent that they: (a) have made a reasonable investigation into the private company in anticipation of the transaction; (b) are not aware of material facts casting doubt on the accuracy of the information contained therein; and (c) believe that the information fairly presents the financial condition of the company. The SEC could flesh out its view of what such an investigation should entail, possibly incorporating standards reflecting industry best practices. Form RM would then become one of the necessary inputs with respect to recommendations and sales by other broker-dealers under Rule 15c2-11¹²⁰ and its FINRA complement with respect to reverse-merger-initiated transactions.¹²¹

Because of the opacity of low-end trading markets, this kind of intervention could not hope to be successful without some step up in accountability. This has long proved elusive for the SEC itself and FINRA, and hence some increase in private litigation exposure seems warranted. The due diligence representation helps investors by giving them a Rule 10b-5 action for material misdescriptions of the quality of the diligence or other forms of "intentional carelessness." The representation by the shell promoter (not just the shell) is also important following the Supreme Court's recent *Janus Capital* case, which introduces a particularly severe formalism into the question of who is responsible for misstatements in a mandatory disclosure document filed under the name of a particular entity.¹²² This is also a place where some restoration of section 12(a)(2) liability would help.

¹²⁰ 17 C.F.R. § 240.15c2-11 (2012).

¹²¹ FINRA, FORM 211, *available at* <http://www.finra.org/Industry/Compliance/MarketTransparency/OTCBB/Forms/> (notifying issuers of information that broker-dealer must have in its possession before posting quotes for issuer's stock).

¹²² See *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2306 (2011) (holding that the only person who "makes" a misstatement is one with ultimate legal au-

We should note that the Chinese reverse-merger phenomenon has led to additional regulatory change, though not in the form suggested here. The most highly publicized failures involved issuers who listed on a U.S. exchange promptly upon completion of the reverse merger. This was a reputational issue, particularly for NASDAQ, which, together with the other major exchanges, amended its listing standards in November 2011 (upon SEC approval¹²³) to make listing more difficult via this technique. This revision may well be a potent short-term response but we doubt it is a long-term solution given the rapid evolution of alternative trading markets and pressure on listing standards generally as a protective device. We suspect that reverse mergers will remain both practically significant and a challenge to effective regulation.

B. PIPEs

Reverse mergers are sometimes gateways to capital-raising transactions by the private companies that have now become public through legal alchemy; PIPE financing is a standard transactional mechanism for many of those that do.¹²⁴ But PIPEs are important for issuer capital raising well beyond this one context. As the recent financial crisis showed, PIPE financing can be the deal structure of choice even for larger, well-known firms.¹²⁵ Like reverse mergers, PIPE regulation evolved step-by-step rather than by design, so that a multibillion-dollar marketplace came into being with no formal SEC rulemaking deliberation about the optimal approach to that regulation.¹²⁶ Notwithstanding its extraordinary practical importance, however, legal academics paid almost no attention to PIPE regulation

thority over it). For a discussion, see Donald C. Langevoort, *Lies Without Liars? Janus Capital and Conservative Securities Jurisprudence*, 90 WASH. U. L. REV. (forthcoming 2013).

¹²³ See Press Release, Sec. & Exch. Comm'n, *supra* note 96. The new standards call for a one-year "seasoning period" for nonexchange trading after the merger prior to listing. *Id.* (internal quotation marks omitted).

¹²⁴ Joseph, *supra* note 82 ("[I]n 2007 there were 222 reverse mergers completed and 45% of them included a concurrent PIPE, raising approximately \$1 billion."). Large companies were the earliest users of this transactional form which then became popular with smaller issuers.

¹²⁵ See Jeffrey Marell & Tracey Zacccone, *PIPEs: Raising Equity Capital in Uncertain Times*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 3, 2009, 10:58 PM), <http://blogs.law.harvard.edu/corpgov/2009/06/03>. The Berkshire Hathaway investment in both General Electric and Goldman Sachs were PIPE transactions, as was KKR's in Sun Microsystems. See DAVID P. STOWELL, *INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY* 331 (2d ed. 2013). For useful data on the use of PIPE financing, see Susan Chaplinsky & David Haushalter, *Financing Under Extreme Risk: Contract Terms and Returns to Private Investments in Public Equity*, 23 REV. FIN. STUD. 2789, 2794–95, 2797–802 (2010).

¹²⁶ From 1995 to 2010, some 17,000 PIPE deals raised approximately \$460 billion; in 2007 alone there were 1,249 PIPE deals, which raised approximately \$56 billion in capital. See Na Dai, *Monitoring via Staging: Evidence from Private Investments in Public Equity*, 35 J. BANKING & FIN. 3417, 3417 (2011); Na Dai, *The Rise of the PIPE Market*, in *PRIVATE EQUITY*:

until recently. In securities regulation casebooks and other analytic discussions, the topic is often relegated to a short note, if mentioned at all. PIPE regulation is perhaps the most important in a category of hybrid financing techniques (such as rights offerings, directed selling programs, and the like) that receive less attention than they should outside a relatively small circle of legal specialists who understand their strange “metaphysics.”¹²⁷

PIPE deals have many variations in how they can be structured.¹²⁸ Their common feature, however, is fairly straightforward: the issuer does an exempt private placement with a small number of investors who would thus ordinarily have to hold those securities for the duration of the Rule 144 holding period.¹²⁹ But many issuers in PIPE transactions have been smaller, financially challenged, and with questionable future prospects, so that even a six-month illiquidity risk is substantial. The solution is a registration rights agreement: the issuer agrees to file a registration statement with the SEC to permit the investors’ resales into the public markets as soon as it is declared effective.¹³⁰ This procedure shortens the period of illiquidity for the investors and thereby overcomes what might otherwise be an insuperable obstacle to their participation. The gain to the issuer is clear enough: it gets its money (which is often badly needed) upon closing the private placement sooner rather than later. The private placement can also be done confidentially, avoiding the downward price pressure associated with public disclosure.

The economics here are interesting. Traditionally registered equity offerings (whether IPOs or seasoned offerings) work well when, through disclosure, information-asymmetry barriers can reasonably be overcome, but they are less attractive when the company’s operations or prospects remain highly opaque even in the face of conventional financial disclosure.¹³¹ PIPE financing is generally seen as a solution to conditions of high informational asymmetry.¹³² With the assistance of a placement agent, PIPE investors—which can be hedge funds, venture capital providers, or other kinds of institutional investors—bring knowledge and skill to bear in the private negotiation, leading to the

FUND TYPES, RISKS AND RETURNS, AND REGULATION 111, 111–12 (Douglas Cumming ed., 2010).

¹²⁷ See, e.g., Stanley Keller, *Basic Securities Act Concepts Revisited*, INSIGHTS, May 1995, at 5, 9.

¹²⁸ See Sjostrom, *PIPEs*, *supra* note 21, at 383–85. For an extensive practical discussion of how PIPE deals are done, see 1 ANNA T. PINEDO & JAMES R. TANENBAUM, *EXEMPT AND HYBRID SECURITIES OFFERINGS* chs. 13–15 (2011).

¹²⁹ See Sjostrom, *PIPEs*, *supra* note 21, at 382.

¹³⁰ See *id.* at 383.

¹³¹ See Hsuan-Chi Chen et al., *The Choice of Equity Selling Mechanisms: PIPEs Versus SEOs*, 16 J. CORP. FIN. 104, 107 (2010).

¹³² See *id.*

discount from the prevailing market price at which the investors are willing to buy the securities. That discount is often sizable.¹³³ To the extent practicable, the investors then hedge their risk by short selling the issuers' securities as soon as the PIPE deal is publicly announced. Under the right conditions, the willingness of reputable investors to take on the risk is a positive signal about the otherwise financially challenged issuer.

Because the first step (the private placement) is unregulated, this is simply a matter of bargaining power, and the issuer may well be disadvantaged by its need for cash and paucity of other options. The terms can be harsh and severely dilutive of existing shareholders, but that does not necessarily indicate anything wrong so long as management is bargaining the best it can. The second step—the follow-on registration—brings '33 Act registration into play.¹³⁴ All sorts of complex problems have arisen: for instance, section 5 liability associated with short selling by the investors¹³⁵ or insider trading if the direction of the price move upon public announcement is predictable.¹³⁶

The regulatory question here of interest pertains to the characterization of public resale that takes place upon the effectiveness of the issuer's registration statement. For all practical purposes, the two steps are part of a single plan of capital raising by the issuer so that the issuer seems to be engaged in a public sale of securities through the short-term parking of the securities in the hands of institutional intermediaries (underwriters). If so, the issuer and the PIPE investors face substantial section 11 liability risks which in turn would impel the

¹³³ The fact of a discount is not surprising. There are often discounts for seasoned equity offerings if, for example, the market takes management's choice to pursue this form of fundraising over other options as new information that management views the firm's stock as overvalued. The issue is how large the discount will be. For a comparison of discounts in the SEO and PIPE setting, see Na Dai & Hsuan-Chi Chen, *Seasoned Equity Selling Mechanisms: Costs and Innovations*, J. PRIVATE EQUITY, Summer 2008, at 16, 23 (estimating average discount at 31.5% for PIPEs, more than eight times the SEO discount, plus an agent fee of around 7%). Many PIPE issuers are heavily involved in research and use funds to continue such efforts as the cash burn accelerates. See James R. Brown & Ioannis V. Floros, *Access to Private Equity and Real Firm Activity: Evidence from PIPEs*, 18 J. CORP. FIN. 151, 156–57, 163 (2012) (displaying data showing amount of investment in research and design for PIPE issuers).

¹³⁴ As a technical matter, the key legal step that makes the PIPE transaction work is the determination that the first and second steps are not "integrated" into a single transaction. See 17 C.F.R. § 230.152 (2013) (providing that integration is not automatic simply because private placement is followed by registered offering). This question is one of the most technically challenging of the "metaphysics" in this area, but it is not our particular focus here.

¹³⁵ See SEC v. Lyon, 529 F. Supp. 2d 444, 450 (S.D.N.Y. 2008).

¹³⁶ See Sjostrom, *PIPEs*, *supra* note 21, at 410–12 (describing SEC enforcement actions regarding insider trading). The best known of these enforcement actions involves the sports entrepreneur Mark Cuban. See SEC v. Cuban, 620 F.3d 551, 552 (5th Cir. 2010).

kind of due diligence typically associated with a registered offering, limiting regulatory worry about such deals.

But the economics are such that PIPE buyers are unwilling to take part in these deals if indeed exposed to such liability—the risk (and related registration burdens) is simply too great. Thus, PIPE regulation proceeds on the fiction that the institutions are just ordinary selling shareholders whose public resales are being facilitated by the registration rather than purchasers who bought from the issuer with a view toward a distribution (clearly so) or assisted the issuer in a distribution of its securities (ditto).¹³⁷ As a result, registration is simplified via shelf registration, taking advantage of incorporation by reference to the issuer's periodic filings and with less scrutiny of the offering by the SEC. The issuer remains on the section 11 hook along with insiders, directors, and auditors. However, since PIPE issuers are often financially challenged, a bad offering will frequently be followed by insolvency, making the issuer a poor litigation target, and the others may not have particularly deep pockets either. The missing underwriters could make a difference.

In the mid-2000s, after finding much not to like about certain PIPE deals in terms of insider trading, short-selling concerns, and deal structures that seemed toxic to the issuer and its existing shareholders, the SEC staff informally shifted course. In addition to some high-profile enforcement actions, the staff signaled that the primary-secondary distinction could not be taken for granted and that PIPE deals whose size was greater than one-third of the issuer's already-outstanding shares might be considered primary and thus not eligible for the simplified selling-shareholder treatment.¹³⁸ PIPE investors would then risk being considered statutory underwriters. To this extent, the window was partly closed. The reaction to the SEC's informal shift was negative not just in the business and legal community—which had by that time developed a large appetite for PIPEs—but also in the academic literature.¹³⁹

For the reasons noted, underwriter status seems almost conceptually self-evident, whether or not the offering passes the one-third threshold. PIPE investors are buying from the issuer with a view to-

¹³⁷ See Sjostrom, *PIPEs*, *supra* note 21, at 410 (noting investors' regulatory arbitrage by avoiding underwriter obligations).

¹³⁸ See Stanley Keller & William Hicks, *Unblocking Clogged PIPEs: SEC Focuses on Availability of Rule 415*, *INSIGHTS*, May 2007, at 2, 3–4; Anna T. Pinedo & James R. Tanenbaum, *When a Primary is Not a Primary*, *INT'L FIN. L. REV.*, May 2007, at 26, 27. Factors examined in the inquiry (largely with respect to greater-than-one-third transactions) could include the potential "toxicity" of the PIPE arrangement, the quality of disclosure, and the likely speed and aggressiveness of resale—suggesting that the SEC staff is simply making a subjective assessment of the risk to investors.

¹³⁹ See, e.g., Sjostrom, *PIPEs*, *supra* note 21, at 411–12 ("[T]he exact policy justification for the reinterpretation remains unclear.").

ward a distribution of the securities and assisting the issuer in a de facto distribution.¹⁴⁰ The staff had given away much of the "underwriter" definition to these new practices until it partly pulled back. So why the criticism?

The argument mainly is that financially challenged firms *need* the speed and simplicity that PIPE deals afford—such firms are out of other options. But that reference to capital formation in and of itself cannot be a satisfactory argument unless it is simply allowed to trump investor protection (which only now may seem plausible following the JOBS Act). The argument tends to continue by emphasizing the deal flexibility and the ability of sophisticated institutional investors to solve the otherwise vexing issues associated with high informational asymmetry. That we will take as so, but it is not particularly important if all that the PIPE investors are doing is parking the securities for a short while and being highly compensated for doing so.

The question that receives too little attention—but which is ultimately crucial to the policy discussion—is how the public investors who buy from PIPE investors fare. We know relatively little here except for some evidence that the average long-term performance of PIPE-issued securities appears to be negative (although that is true for IPOs too).¹⁴¹ What is missing is any serious exploration of when and how aggressively PIPE investors dispose of their shares after the effectiveness of the registration. If shares are held even after the effective date and only gradually dispersed into the public markets, we have less cause for concern; if they are dumped promptly via heavy broker-dealer marketing efforts, then we have more to worry about.

The evidence suggests substantial variation, both over time and depending on the particular deal. Some PIPE investors are venture-capital funds that, while gaining the right to resell, tend to hold and engage in serious monitoring efforts while they remain invested. This behavior is typically a positive signal to the market and not surprisingly leads to a stock price increase upon announcement. The investors do their diligence, though perhaps not as much as when they are more tightly locked in to the investment. By contrast, ordinary hedge funds have no reputation for sticking around, and the stock price re-

¹⁴⁰ In part, the acquiescence in non-underwriter treatment was an outgrowth of the SEC staff's abandonment of the so-called "presumptive underwriter" doctrine, which had treated large institutional investors in a public offering as underwriters. See 2 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 1114 n.577 (3d ed. 1989) (analyzing the presumptive underwriting doctrine). However, there are significant differences between that general context and the situation where hedge funds and other financial institutions make their financing available pursuant to an understanding that facilitates prompt resales.

¹⁴¹ See, e.g., Chen et al., *supra* note 131, at 105 ("Market-adjusted returns over longer intervals . . . [show] PIPEs displaying the weaker performance [as compared to SEOs].").

action to their presence as PIPE investors seems to be negative.¹⁴² Other deals with more reputable intermediaries probably fall in between.¹⁴³

Were we able to trust the marketplace of public investors to read these signals well, price adjustment might provide adequate protection. But these deals often take place in thinly traded markets where efficiency properties are not especially strong and where skillful broker-dealer pumping practices can be particularly effective. Without knowing more about the resale markets, we have to be tentative; however, it does not seem for now that the SEC staff was being particularly unreasonable in its policymaking. Public investors lose a significant component of certified due diligence in PIPE deals, even under circumstances where it could be helpful. The staff's one-third rule of thumb is a way of saying that the more stock to be issued, the heavier the resale marketing pressure may be and hence the greater the risk associated with the loss of diligence. As we have been emphasizing throughout this section, it all comes back to the likelihood of sales pressure.

To be sure, critics can always play the capital-formation trump card and argue that the value of PIPE financing as a transaction of last resort for challenged issuers outweighs any increased risk to investors.¹⁴⁴ Admittedly, there are other incentives toward candor even in the absence of underwriter treatment. Ultimately, the question is an empirical one about which not enough is known. But we remain suspicious.

That is not to say, by any means, that PIPE financing should be shut off; it certainly has provided a needed outlet for some issuers. As with reverse mergers, there are some alternative regulatory possibilities. One would be to tolerate treatment of PIPEs as secondary offerings but restrict the use of shelf-registration procedures or otherwise involve more SEC staff in the review process before effectiveness. At a time of diminished resources, however, that may not be feasible. Another relatively mild possibility would be to insist that the PIPE investors and placement agent file a statement with the SEC as a condition

¹⁴² See David J. Brophy et al., *Hedge Funds as Investors of Last Resort?*, 22 REV. FIN. STUD. 541, 542–43, 563 (2009); Na Dai, *Does Investor Identity Matter? An Empirical Examination of Investments by Venture Capital Funds and Hedge Funds in PIPEs*, 13 J. CORP. FIN. 538, 561–62 (2007).

¹⁴³ The placement agents vary in reputation as well. See Na Dai et al., *The Quality and Price of Investment Banks' Service: Evidence from the PIPE Market*, 39 FIN. MGMT. 585, 594 (2010).

¹⁴⁴ See, e.g., *Tougher SEC Standards Are Clogging the PIPE-Line*, TURNAROUND MGMT. ASS'N (May 1, 2007), <http://www.turnaround.org/Publications/Articles.aspx?ObjectId=7554&Mode=> ("While PIPE offerings by distressed companies can be highly costly and risky to public shareholders, they may also represent the company's last best chance to correct its financial course before bankruptcy . . .").

for secondary offering treatment describing what, if any, due diligence efforts were undertaken and representing that they are not aware of any false or misleading material misstatements or omissions in the issuer's registration statement. This could be coupled with a more forthcoming description of any plans or arrangements for the distribution of the securities after effectiveness. We would at least know more at relatively little marginal cost.

III

THE JOBS ACT INNOVATIONS

The JOBS Act resets the public-private boundary for the '33 Act by expanding issuers' ability to use small offering exemptions or make private placements to accredited investors without having to satisfy the demands of a registered public offering.¹⁴⁵ Of the three major JOBS Act efforts to enhance '33 Act capital raising without the burdens of registration—"crowdfunding," the new "Reg A+" exemption, and the removal of the ban on general solicitation for private placements to accredited investors under Rule 506—we think that the last of these will be where the JOBS Act has its most substantial impact, raising issues similar to those explored in Part II but with far greater intensity.

A. Crowdfunding and "Reg A+"

The JOBS Act crowdfunding exemption found in the new section 4(a)(6) is difficult to evaluate because the final version that emerged from the political process is conceptually incoherent. Its original backers had wanted a nearly regulation-free zone wherein start-ups and other early stage issuers could at little cost use the Internet, either directly or through funding portals, to display their business plan and seek out small investors who share their entrepreneurial dream, however risky it might be.¹⁴⁶ With relatively minor exceptions, the main investor protection would have come through wealth- and income-based limits on how much any single investor could invest (and thus lose) in any one venture as well as a one million dollar cap on how much the issuer could raise in any transaction. In contrast to the current Rule 504 in Reg D, which has a similar dollar cap for issuers and no mandatory disclosure requirements,¹⁴⁷ advertising and other solici-

¹⁴⁵ See Press Release, Sec. & Exch. Comm'n, SEC Approves JOBS Act Requirement to Lift General Solicitation Ban (July 10, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539707782#.UgDu8FvD-po>; Vincent Ryan, *Advertise, but Verify*, CFO.COM (Nov. 15, 2012), http://www3.cfo.com/article/2012/11/capital-markets_private-placement-general-solicitation-rule-506-offerings-jobs-act.

¹⁴⁶ For a good discussion of the background and legislative history, see C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195, 199–201 (2012).

¹⁴⁷ See 17 C.F.R. § 230.504 (2013).

tations would be permitted, and, crucially, state blue-sky registration of the offering would be preempted—a characteristic that Rule 504 offerings lack. Enthusiasts for crowdfunding stressed that Internet offerings would harness the “wisdom of the crowds” to separate the good business plans from the deficient (or corrupt).¹⁴⁸ A bill reflecting this deregulatory vision passed the House by a wide margin.¹⁴⁹

This was the most heavily criticized portion of the multiple bills that were folded into the JOBS legislation; investor advocates noted the substantial freedom of “portal” entrepreneurs to emerge in boiler-room fashion to promote risky stock without any registration or disclosure obligations and pointed out many instances when crowds have been duped.¹⁵⁰ This is where key members of the Senate balked. A last-minute compromise emerged that substantially revised the crowdfunding definitions and conditions. But in the process, the compromise turned a regulation-free zone into a quite heavy and costly set of responsibilities on both issuers and any intermediaries that assist them¹⁵¹—so much so that it is difficult for us to see why a rational start-up entrepreneur would find it appealing to use the new 4(a)(6) exemption at all. Our prediction is that unless the SEC turns its back on serious rulemaking and enforcement in this area, this will not turn out to be particularly fertile ground for start-up capital-raising activity; the regulatory costs are likely to take too much of the

¹⁴⁸ See Kanyi Maqubela, *The Power and the Peril of Our Crowdfunded Future*, ATLANTIC (July 2, 2012, 11:47 AM), <http://www.theatlantic.com/technology/archive/2012/07/the-power-and-the-peril-of-our-crowdfunded-future/259304/>. This is not a necessary assumption, of course. Other proponents of the exemption rested their case on the simple belief that if people wanted to risk a limited amount of their money on a dream, the government should not stop them, especially if the money might spark a greater level of entrepreneurship.

¹⁴⁹ See Maria Lokshin, *House Approves Bills to Exempt Crowdfunding, Lift General Solicitation Ban*, 43 SEC. REG. & L. REP. (BNA) 2246 (Nov. 7, 2011) (reporting a vote of 407 to 17).

¹⁵⁰ See, e.g., *Spurring Job Growth Through Capital Formation While Protecting Investors: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. (2011) (statement of John C. Coffee, Jr., Professor, Columbia University Law School), available at http://www.law.columbia.edu/null/download?&exclusive=filemgr.download&file_id=62588 (“Failure to adopt this approach (or some similar variant) would likely mean that every barroom in America could become a securities market, as some unregistered salesman, vaguely resembling Danny DeVito, could set up shop to market securities under the ‘crowdfunding exemption.’”). Key SEC officials, including Chairman Mary Schapiro, also spoke publicly about their concerns with the House’s crowdfunding exemption. See Yin Wilczek, *Schapiro Faults JOBS Bill for Gaps in Investor Protection, Short Deadlines*, 44 SEC. REG. & L. REP. (BNA) 560 (Mar. 19, 2012).

¹⁵¹ See Maria Lokshin, *Senate Passes Amended ‘JOBS Act’; Cantor to Schedule House Vote Soon*, 44 SEC. REG. & L. REP. (BNA) 597 (Mar. 26, 2012). The Senate amendments included extensive disclosure requirements for issuers and registration (and FINRA supervision) for portals.

small amount of money that can be raised even if portals absorb some of the anticipated costs.¹⁵²

Others have explored crowdfunding both pre- and post-JOBS Act from a variety of perspectives,¹⁵³ and we do not need to repeat their analysis. We think that there might be a good case for allowing some level of crowdfunding, at least through a (presumably small) number of registered portals that have satisfied the SEC that they have robust plans for dealing with the rather obvious and inevitable temptations for abuse, including fraud, manipulation, exploitation of investor ignorance, violations of issuer and investor caps, and the like.¹⁵⁴ But this is far from either the initial or final versions of section 4(a)(6) and so we limit our comments to a few points that connect to our broader interests. First, regarding the so-called wisdom of crowds¹⁵⁵: There are actually two ideas at work here, somewhat in tension. One is that exposing an entrepreneur's idea to an open forum allows for communication among interested parties, allowing the crowd's collective reaction to elicit new information—someone with knowledge, for example, sharing that an otherwise exciting vision risks a patent violation.¹⁵⁶ Yet nothing in the legislation insists on any such openness.¹⁵⁷ That is actually a harder issue than it seems because the wisdom-of-crowds literature stresses that open communication may also have a downside, introducing the risk of anchoring crowd-

¹⁵² See Yin Wilczek, *SEC, Crowdfunding Participants Headed for Culture Clash Under Pending Regime*, 44 SEC. REG. & L. REP. (BNA) 1524 (Aug. 13, 2012).

¹⁵³ For post-JOBS Act perspectives, see, for example, Bradford, *supra* note 146. See generally Stuart R. Cohn, *The New Crowdfunding Registration Exemption: Good Idea, Bad Execution*, 64 FLA. L. REV. 1433 (2012) (discussing the substantial regulatory costs of the crowdfunding exemption); Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735 (2012) (discussing the need for meaningful disclosures to protect investors). For pre-JOBS Act perspectives, see, for example, C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1 [hereinafter Bradford, *Crowdfunding and the Federal Securities Laws*] (discussing expensive registration requirements and the danger that the SEC may consider websites that facilitate crowdsourcing brokers or investment advisors and advocating for a crowdsourcing exemption); Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879 (2011) (advocating for a crowdsourcing exemption).

¹⁵⁴ The key would seem to be the emergence of portals with the incentive to self-police, doing some of the due diligence necessary to prevent fraud. This is likely to come, at least initially, by channeling crowdfunding opportunities to portals with large enough volume and order flow to justify the commitment and survive for the long run.

¹⁵⁵ For an in-depth discussion of the wisdom of crowds, see generally JAMES SUROWIECKI, *THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS, ECONOMIES, SOCIETIES, AND NATIONS* (2004).

¹⁵⁶ See *id.* at 10 (describing each person's access to private information as a characteristic of wise crowds).

¹⁵⁷ See generally Bradford, *Crowdfunding and the Federal Securities Laws*, *supra* note 153, at 6–23 (discussing the crowdsourcing exemption's requirements).

members' beliefs and undermining the averaging effect of many independent beliefs.¹⁵⁸ Suffice it to say that the final compromise version of section 4(a)(6) has none of the mechanisms built in that might make equity crowdfunding resemble the kinds of markets that have emerged in other contexts.¹⁵⁹ Indeed, the final compromise version makes the exemption available to an issuer that uses either a funding portal *or* a broker-dealer firm to raise the capital.¹⁶⁰ The latter obviously raises a serious sales pressure concern—a marginal issuer can find a marginal broker to do cold-call telephone solicitations and invoke the exemption from mandatory disclosure and state regulation. Obviously, this is far distant from the vision said to justify crowdfunding; those cold calls (or e-mail spam) will be exposed to neither a crowd nor much likelihood of any wisdom.¹⁶¹

Finally, note that the JOBS Act contains an interesting reversal of *Gustafson* for cases of crowdfunding fraud or misrepresentation. Liability for material misstatements or omissions in crowdfunding tracks the negligence-based standard of section 12(a)(2), as Congress chose to make it “as if the liability were created under section 12(a)(2).”¹⁶² Liability is shared not just by the issuer but also by directors, partners, and principal executive and financial officers, an extension of liability that can be expected to increase the level of due diligence in these

¹⁵⁸ See Richard P. Larrick et al., *The Social Psychology of the Wisdom of Crowds*, in SOCIAL JUDGMENT AND DECISION MAKING 227, 232–33 (Joachim I. Krueger ed., 2012).

¹⁵⁹ Most notably, there is no way to bet profitably against the entrepreneur. Even in highly organized trading markets, short selling appears to be necessary to keep buy-side optimism in check. See Andrei Shleifer & Robert W. Vishny, *The Limits of Arbitrage*, 52 J. FIN. 35, 49 (1997) (“Casual empiricism suggests that a great deal of professional arbitrage activity . . . is concentrated in . . . markets where extreme leverage, short selling, and performance-based fees are common.”). For a discussion of prediction markets which seek to harness crowd wisdom, see generally MICHAEL ABRAMOWICZ, *PREDICTOCRACY: MARKET MECHANISMS FOR PUBLIC AND PRIVATE DECISION MAKING* (2007).

¹⁶⁰ Jumpstart Our Business Startups Act, Pub. L. No. 112–106, § 302(a), 126 Stat. 306, 315 (2012) (to be codified at 15 U.S.C. 77d(6)(C)) (adding § 4(6)(C) to the Securities Act of 1933).

¹⁶¹ The requirement in the final version of the legislation that a funding portal or broker be used was obviously designed to prevent issuer “Internet-direct” solicitations, where start-ups use their own visibility to attract investors. Whether such offerings are likely to succeed as a practical matter has been debated for some time. See, e.g., Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 75–77 (1998); Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of “Technological Disintermediation” for Unregistered Offerings of Securities*, 2 J. SMALL & EMERGING BUS. L. 1, 7–12 (1998); Sjoström, *Internet Direct Offerings*, *supra* note 21, at 581–85. That aside, there may be some justification for permitting outreach efforts by issuers who display information on their own websites and (perhaps) communicate as to their interest in capital. See U.S. SEC. & EXCH. COMM’N, FINAL REPORT OF THE SEC ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE U.S. SECURITIES AND EXCHANGE COMMISSION 75–77 (2006), available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>.

¹⁶² Jumpstart Our Business Startups Act § 302(b) (adding section 4A(c)(1)(B) to the Securities Act of 1933).

offerings.¹⁶³ In this sense, Congress was acting well within the familiar template of securities regulation strategies in response to the sales pressure concerns.

The JOBS Act also directs the SEC to promulgate a new set of rules under section 3(b) for offerings up to fifty million dollars, building on the current “mini-registration” process under Reg A (thus the nickname “Reg A+” for the yet-to-be-promulgated regulation). Disclosure must include audited financial statements and such other disclosures as the SEC may determine necessary in the public interest.¹⁶⁴ The precise terms must await SEC rulemaking, but the contours that Congress has directed in the statute suggest the type of scaled regulation that currently exists for Reg A.¹⁶⁵ It would be surprising if the SEC requires less disclosure for this new offering than it already requires for the existing section 3(b) offering, which covers offerings only one tenth of the size permitted by the new exemption. As for liability, Congress specified that section 12(a)(2) will apply to any person offering or selling securities in this new format.¹⁶⁶ So here again, we have substantial investor protections of the sort well within our template. Precisely for this reason, however, we wonder how attractive this new exemption will be to entrepreneurs given that layering of protections, although the expansion of the cap to fifty million dollars offers broader potential for a favorable cost-benefit balance as issuers are able to spread costs over a larger amount. This will depend in part on whether there are more appealing capital-raising routes available,¹⁶⁷ and we now turn to a venue that may well indeed be more attractive.

¹⁶³ *Id.* (adding § 4A(c)(3) to the Securities Act of 1933 and defining “issuer” to include the other named parties).

¹⁶⁴ Jumpstart Our Business Startups Act § 401 (striking section 3(b) of the Securities Act of 1933 and replacing it with a new section 3(b)).

¹⁶⁵ See 17 C.F.R. §§ 230.251–263 (2013).

¹⁶⁶ See Jumpstart Our Business Startups Act § 401 (adding § 3(b)(2)(D) to the Securities Act of 1933).

¹⁶⁷ Reg A’s history is instructive. It nearly disappeared after Reg D came into effect because the freedom under the latter dominated Reg A’s many exacting requirements. It reemerged from dormancy when the SEC loosened its marketing restrictions to allow for “testing the waters” through advertising and other sales effort without making any comparable change to the general solicitation ban in Reg D. *Cf. COX ET AL., supra* note 66, at 319–23 (noting a positive response to Reg A’s “testing the waters” initiative and indicating that if the testing-the-waters activity was done in such a way that the activity could constitute general solicitation, the issuer should wait six months before proceeding with a Reg D offering in order to avoid integration problems that would raise general solicitation concerns (internal quotation marks omitted)); Rutheford B. Campbell, Jr., *Regulation A: Small Business’ Search for “A Moderate Capital”*, 31 DEL. J. CORP. L. 77, 82–83 (2006) (describing the non-use of Reg A). But the latter is just what the JOBS Act has also changed, as we are about to see.

B. Rule 506 and General Solicitations

1. *The Original Assumption*

Private placements have been a part of the '33 Act landscape from the statute's enactment, a private space where issuers can make offerings free of the publicness obligations of a registered public offering. James Landis, a principal drafter of the '33 Act and the SEC's second chairman, explained the original section 4(2) exemption by reference to "[t]he sale of an issue of securities to insurance companies or to a limited group of experienced investors."¹⁶⁸ An early release by the SEC's general counsel identified four core characteristics that necessarily limited the use of the exemption. What was private was defined by characteristics that negated publicness—there could only be a small number of offerees and they had to be linked to the issuer by access or relationship, requirements that would practically preclude an offering to a large number of investors.¹⁶⁹ A ban on general solicitation of offerees, our focus in terms of the JOBS Act change, was thus implicit in the approach to private placements from the beginning. Offers made to the public could not fit within an exemption specifically defined as nonpublic.

As we have seen, the Supreme Court's first and only explication of this exemption in *Ralston Purina*, two decades into the '33 Act's life, linked the defining characteristics to the policy of those who could fend for themselves, for whom the protections of the '33 Act were not necessary. Appellate court interpretations through the next two and a half decades suggested a narrow reading of such a group—even seemingly narrowed further at times to include only insiders or those with a similar close relationship to the issuer, or to take in those who had sophistication or access to information that would provide them with the means to protect themselves.¹⁷⁰ Again, this narrow conception of the exemption effectively ruled out aggressive marketing to a broad audience of potential investors, even fairly sophisticated ones.

This early reading of the section 4(2) exemption meant that such deals were negotiated and not (simply) sold.¹⁷¹ And that was consis-

¹⁶⁸ James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 37 (1959).

¹⁶⁹ See Securities Act Release No. 285, 1935 WL 27785 (Jan. 24, 1935).

¹⁷⁰ Cf. COX ET AL. *supra* note 66, at 271–80 (discussing *SEC v. Ralston Purina*, 346 U.S. 119 (1953) and other Fifth Circuit decisions discussing this exemption).

¹⁷¹ See, e.g., Manuel F. Cohen, *Federal Legislation Affecting the Public Offering of Securities*, 28 GEO. WASH. L. REV. 119, 142 n.64 (1959) ("Private placements had their beginnings and early development in the negotiated sale of specially tailored debt securities to a limited number of large institutional investors who were in a position to insist upon and receive more information than that provided by registration and to require such protective covenants or restrictions which, together with their ability to supervise constantly and to take appropriate action instantly, supported the view that such offerings were non-public in

tent with the theme we have been stressing throughout this Article. When a concentrated group of sophisticated purchasers negotiates with the issuer, the purchasers are in a position to bargain for information and its credibility through representations and warranties. In this sense, they can choose the level of due diligence expected of the issuer and other offering participants. Contract law remedies are ample in the event of a breach, supplemented by tort law with respect to misrepresentations that induce the transaction in the first place. In this original understanding of the private-placement exemption, what later became the holding in *Gustafson* would make sense.¹⁷² There is no real need for a federal liability supplement such as that found in section 12(a)(2) where bargaining among a limited number of sophisticated parties will create its own set of protections. And it is not particularly surprising that this distinction between offerings that are negotiated with a small group and those that are sold to dispersed investors became significant in other contexts as well, such as determining whether what is being distributed is a security in the first place.¹⁷³

2. *The Transition to Reg D*

The early conception of what constituted an exempt private offering was frustrating and distasteful to entrepreneurs and securities firms who wanted to be more aggressive in finding sources of capital without filing a registration statement or doing a mini-registration Reg A offering. In response to this pressure, SEC rulemaking provided a safe harbor that effectively widened the exemption in the 1970s and early 1980s. The first experiment, Rule 146, was promulgated in 1974 and based suitability not just on sophistication but alternatively on the ability to bear economic risk.¹⁷⁴ But that was still seen as too subjective a standard for promoters who wanted to be sure that their sales efforts would not violate the '33 Act's registration requirement.¹⁷⁵ The regulatory alchemy finally came with the adoption of Reg D in 1982, shortly after Congress had nudged the SEC toward liberalization by adopting a JOBS Act predecessor, the Small Business Investment

character for which the protections of the registration provisions were probably unnecessary.").

¹⁷² See Peter V. Letsou, *The Scope of Section 12(2) of the Securities Act of 1933: A Legal and Economic Analysis*, 45 EMORY L.J. 95, 128-33 (1996).

¹⁷³ See, e.g., *Reves v. Ernst & Young*, 494 U.S. 56, 68 (1990) (stating that a widespread "plan of distribution" indicates that a note is a security); *Marine Bank v. Weaver*, 455 U.S. 551, 559-60 (1982) (stating that an individual negotiation points against security status).

¹⁷⁴ See Securities Act Release No. 5487, 39 Fed. Reg. 15,261, 15,261-62 (May 2, 1974).

¹⁷⁵ See Ruthford B. Campbell, Jr., *The Plight of Small Issuers Under the Securities Act of 1933: Practical Foreclosure from the Capital Market*, 1977 DUKE L.J. 1139, 1143-47.

Incentive Act of 1980.¹⁷⁶ The SEC's dramatic step came through a definition of "accredited investors" that created a class of persons *whose wealth alone* would satisfy this standard. The term included not only banks and institutional investors but also individual investors with what were then distinctly upper-class incomes (two hundred thousand dollars per year) or net worth (one million dollars).¹⁷⁷

Capital-raising transactions under Rule 506, if directed solely at accredited investors, did not mandate disclosure, did not require sophistication or an offeree representative, and could be directed at an unlimited number of potential purchasers, all without any upper dollar limit.¹⁷⁸ Not only did this shift to wealth as a metric lessen the likely sophistication that purchasers would bring to the transactions,¹⁷⁹ but it also made salesmanship an attractive possibility. There could be marketing of deals to many widely scattered investors rather than negotiations with empowered principals or bargaining agents. In that light, contract tools become less reliable, and the usual securities-law principles encouraging due diligence become more valuable—in other words, we came closer to the set of concerns about sales pressure that we believe motivated the '33 Act in the first place.

This policy shift—nearly invisible in the text of the safe harbors themselves—was momentous and ideologically charged, very much the product of the Reagan-era deregulatory impulse that took hold in

¹⁷⁶ Pub. L. No. 96-477, 94 Stat. 2275 (1980) (codified in scattered sections of 15 U.S.C.). Congress created an accredited-investor exemption in the past but without reference to an individual's wealth as a standard. The SEC had experimented with a wealth-based exemption in its short-lived Rule 242, but it only exempted large block purchasers as accredited investors. See Susan E. Satkowski, Note, *Rule 242 and Section 4(6) Securities Registration Exemptions: Recent Attempts to Aid Small Businesses*, 23 WM. & MARY L. REV. 73, 81–82 (1981).

¹⁷⁷ See 17 C.F.R. § 230.501(a)(5)–(6) (2012) (defining "accredited investor").

¹⁷⁸ See Rutheford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 BUS. LAW. 919, 933 (2011). The exemption could also be used for nonaccredited investors if there are less than thirty-five and if their representative satisfied a sophistication standard. See *id.* at 921, 925. The inclusion of nonaccredited investors initially required that all investors (accredited or nonaccredited) receive disclosures, but that requirement has since been cut back to just nonaccredited investors. Compare 17 C.F.R. § 230.502(b)(1)(ii) (1983) (requiring disclosures to both accredited and nonaccredited investors if nonaccredited investors were purchasers), with 17 C.F.R. § 230.502(b)(1) (2012) (requiring disclosures only to nonaccredited investors if nonaccredited investors are purchasers). In any case, it was the accredited market that drove the growth in the use of the rule. See Campbell, *supra*, at 929 (reporting that in 2010 there were no nonaccredited investors in 91.2% of Rule 506 offerings).

¹⁷⁹ See Howard M. Friedman, *On Being Rich, Accredited, and Undiversified: The Lacunae in Contemporary Securities Regulation*, 47 OKLA. L. REV. 291, 299–301 (1994); Manning Gilbert Warren III, *A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933*, 33 AM. U. L. REV. 355, 382 (1984) ("Experience indicates that the wealthy often do not have the sophistication to demand access to material information or otherwise to evaluate the merits and risks of a prospective investment.").

the early 1980s.¹⁸⁰ In essence, the treatment of accredited investors in Reg D was premised on the idea that such persons would (or at least should be expected to) fend for themselves without any more help from regulation than a prohibition against fraud and other ancillary protections found in other statutes. '33 Act registration was thus implicitly cast as an exercise in paternalism, unnecessary and potentially disruptive when contractual freedom would suffice. We will pick back up on this thread when we get to the JOBS Act's changes to Rule 506.

However, there were limitations that blunted the impact of this shift at the time of its adoption and hence muted the political controversy. The first such limitation was the dollar figure in the definition of accredited investor: in 1981, an income of two hundred thousand dollars or millionaire status in terms of net worth covered a relatively limited number of very well-off people and did not affect all that many retail investors.¹⁸¹ Second, Rule 506 offerings were restricted as to resale for a fairly lengthy period, meaning that those inclined to trade their securities would not much be interested in these kinds of transactions even if qualified.¹⁸² Third, there was the possibility that state blue-sky regulation would still apply to regulate the private placement.¹⁸³ Fourth, there was the potential of section 12(a)(2) liability.¹⁸⁴ Fifth, there was the ban on general solicitations.¹⁸⁵

The ban on general solicitations seems to be implicit in the section 4(2) exemption that the SEC purported to be interpreting via the Rule 506 safe harbor.¹⁸⁶ Thus, no widespread advertising or marketing was permissible even if targeted only at accredited investors.¹⁸⁷ As construed by the SEC staff in a series of no-action letters, the marketing of Rule 506 offerings required a distinct two-step process wherein a potential investor would first be "qualified" as an accredited investor

¹⁸⁰ See generally Mark A. Sargent, *The New Regulation D: Deregulation, Federalism and the Dynamics of Regulatory Reform*, 68 WASH. U. L.Q. 225, 227 (1990) (discussing the evolution of Regulation D throughout the 1980s).

¹⁸¹ In 1981, there were 138,136 individual income tax returns reporting an adjusted gross income of two hundred thousand dollars or more. See *infra* note 201. According to the earliest available census data on household net worth, only the top 3.5% of U.S. households had a net worth of over half a million dollars in 1991. *Asset Ownership of Households: 1993*, U.S. CENSUS BUREAU, <http://www.census.gov/people/wealth/files/wlth93-4a.pdf> (last visited Aug. 1, 2013).

¹⁸² See 17 C.F.R. § 230.502(d) (2013).

¹⁸³ See Rutheford B. Campbell, Jr., *The Impact of NSMIA on Small Issuers*, 53 BUS. LAW. 575, 579-81 (1998) (describing the obstacles imposed by state regulations on the small business's access to capital market).

¹⁸⁴ See *supra* text accompanying note 166.

¹⁸⁵ See 17 C.F.R. § 230.502(c).

¹⁸⁶ See Securities Act Release No. 6389, 47 Fed. Reg. 11,251, 11,257-58 (Mar. 16, 1982) (noting that Rule 506 relates to exempt transactions under section 4(2) of the Securities Act and that the ban on general solicitation follows Rule 146(c) which is replaced by Rule 506).

¹⁸⁷ See 17 C.F.R. § 230.502(c).

and only thereafter be approached with the specific investment pitch.¹⁸⁸ Effectively—and maybe deliberately—this forced issuers raising capital through a Rule 506 offering to use the (expensive) services of a registered broker-dealer firm which would have the preexisting relationships with investors needed to facilitate this two-step process. That turned out to be extremely frustrating to small-business capital raisers who began a lengthy—and for a long time unsuccessful—campaign to eliminate the ban.¹⁸⁹

In the meantime, however, much changed with respect to Reg D. As we have already seen, amendments to Rule 144 over the last fifteen years quietly, but dramatically, reduced the resale constraints, increasing the roster of those who might be interested in acquiring securities pursuant to a Reg D offering.¹⁹⁰ From the earliest days of federal securities regulation, the '33 Act worked to limit resales in ways that reduced the need to think about resales of securities of companies that did not report under the '34 Act.¹⁹¹ Any resale of the securities before they had come to rest would destroy the exemption of the original offering and leave the reseller exposed. The exact time period was unclear, but the most frequent rule of thumb was three years.¹⁹² The practical result was that investors would not purchase the shares with an expectation of quick resales, dampening any development of a trading market. At the other end, the relatively shorter period of time before a company's IPO created the potential for a shorter gap between the expiration of trading restrictions and the availability of publicness obligations under the '34 Act.

When originally promulgated in 1972, the holding period for using the safe harbor of Rule 144 was three years for shares of companies that were not reporting companies,¹⁹³ the shares that are our focus here. As we have already noted in connection with reverse

¹⁸⁸ For a review of the guidance, see COX ET AL., *supra* note 66, at 291–300.

¹⁸⁹ For a discussion of and citations to these efforts, see generally Stuart R. Cohn, *The Impact of Securities Laws on Developing Companies: Would the Wright Brothers Have Gotten Off the Ground?*, 3 J. SMALL & EMERGING BUS. L. 315 (1999).

¹⁹⁰ See *supra* notes 107–14 and accompanying text (summarizing circumstances under which securities can be resold under Rule 144).

¹⁹¹ The language of section 5's registration requirement is global in its reach and includes resales but section 4(a)(1)'s exemption for transactions other than by an issuer, underwriter, or dealer effectively protects resales unless they are swept into a distribution involving interstate commerce. See 15 U.S.C. §§ 77d(1), 77e (2006 & Supp. V 2011); see also 15 U.S.C. § 77b(11) (defining “underwriter” in terms of a connection to the distribution of securities).

¹⁹² See COX ET AL., *supra* note 66, at 345–48 (“At one time, most practitioners believed investment intent is established if the shares have been held for three years.”).

¹⁹³ See *supra* note 111 and accompanying text. For shares of reporting companies, the holding period was two years. See *id.* An initial purchaser of restricted stock could also resell pursuant to a privately negotiated “4(1½)” exemption or other transaction that would not destroy the original exemption, but such a route is not likely to lead to the intensive selling efforts that would trigger our concern here. See COX ET AL., *supra* note 66,

mergers, in 1997 the SEC reduced the holding period to two years, and in 2007 it further shortened it to one year.¹⁹⁴ Of course, the legal ability to trade doesn't make much difference if there is no market for the shares. But the growth in platforms such as SecondMarket and SharesPost expanded trading outlets for shares not listed in stock exchanges or that otherwise have not become public companies under the '34 Act.¹⁹⁵ The result is that it seems more economically feasible for investors to think about a business plan for acquiring shares in a private placement to hold for a year and then resell, particularly as technology makes it easier to access platforms that facilitate secondary trading. Indeed, we would not be surprised to find brokers willing to facilitate large-scale resales by acquiring restricted securities at the end of the holding period by means of a tender offer which would enable them to turn around and do an intense marketing of a large block of stock, all free of any '33 Act restrictions.¹⁹⁶

Then there was the *Gustafson* case in 1995.¹⁹⁷ Although nothing in Reg D addresses liability, a general assumption at the time was that section 12(a)(2)'s due diligence-forcing negligence standard would apply to offers and sales of securities in exempt transactions.¹⁹⁸ When the Supreme Court squarely held that it did not apply outside the context of a public offering, another restraint on aggressiveness in the sales and marketing of unregistered securities disappeared.¹⁹⁹ Shortly thereafter came Congressional preemption of state blue-sky registration requirements for private placements exempt under Rule 506. This was a less noticed part of a broader legislative effort to eliminate state-law registration burdens for stock exchange-traded companies.²⁰⁰

at 385 ("Broad solicitations and advertising are generally believed to be inconsistent with the Section 4(1 $\frac{1}{2}$) exemption.").

¹⁹⁴ See *supra* notes 113–14 and accompanying text.

¹⁹⁵ See Langevoort & Thompson, *supra* note 13, at 349.

¹⁹⁶ This would depend, of course, on the acquirer not being a control person and thus not being an affiliate of the issuer. See 17 C.F.R. § 230.144(e) (2013) (providing for limitation on amount of securities sold for the account of an affiliate).

¹⁹⁷ *Gustafson v. Alloyd Co.*, 513 U.S. 561 (1995).

¹⁹⁸ See Louis Loss, *The Assault on Securities Act Section 12(2)*, 105 HARV. L. REV. 908, 914–17 (1992) (discussing why section 12(2) liability should not be limited to registered primary offerings).

¹⁹⁹ FINRA rules do require due diligence when a broker-dealer is involved in a private placement. See FINRA, REGULATORY NOTICE 10-22, REGULATION D OFFERINGS 6 (2010), available at <http://www.finra.org/Industry/Regulation/Notices/2010/P121299>. But this is not monitored on a real-time basis; brokers can be sanctioned if, after the fact, the enforcement staff uncovers some lack of compliance, and such cases are relatively rare especially in light of the vast volumes of such transactions.

²⁰⁰ See National Securities Markets Improvement Act of 1996 § 102, 15 U.S.C. § 77r(b)(4)(D) (2006); Campbell, *supra* note 183, at 582–83. Prior to the legislation, there had been frustrating efforts to develop uniformity in a state-level small-offering exemption.

The final pre-JOBS Act change came simply through the passage of time. When adopted, the definition of “accredited investor” contained no provision for adjustment for inflation, and so over the ensuing decades—particularly quickly in the inflationary environment of the early part of that period—the wealth tests brought more and more retail investors into accredited investor status.²⁰¹ By the mid-2000s, such status would attach to many upper-middle-class professionals. And because retirement savings count toward net worth, the increasing reliance on IRAs, 401(k) accounts, and other tax-advantaged savings programs pushed many current and future retirees into that status as well, even if their incomes never came close to two hundred thousand dollars a year and they were depending on that wealth to see them through the rest of their lives.

As a result of these changes in the thirty years since Reg D came into effect, the ban on general solicitations was carrying far more weight than intended in its original design.

3. *The JOBS Act Elimination of the Ban*

The JOBS Act required the SEC to eliminate the prohibition against general solicitation or general advertisements in Rule 506 offerings if the offering is made only to accredited investors.²⁰² The long-fought—now finally successful—campaign to eliminate the ban on general solicitations as applied to offerings directed at accredited investors had a great deal of academic as well as political support for a simple reason: viewed narrowly, it made no sense. If one takes the position that accredited investors can or should fend for themselves—which is the foundational assumption in Rule 506—why was it reasonable to prohibit issuers and their placement agents from actively seeking them out? That some nonaccredited investors might be sucked into the deal (perhaps misrepresenting their qualified status) as a result of the publicity seems to be overly solicitous, especially given the separate requirement reiterated in the post-JOBS Act amendments to Rule 506 that sellers take reasonable steps to assure accredited-only

²⁰¹ JUSTIN BRYAN, INTERNAL REVENUE SERV., STATISTICS OF INCOME BULLETIN: SPRING 2012, HIGH-INCOME TAX RETURNS FOR 2009, at 8 (2012), available at <http://www.irs.gov/pub/irs-soi/12insprbulhignincome.pdf> (reporting that \$200,000 in 1981 dollars would be \$319,508 in 2009 and that individual income tax returns at or above \$200,000 made up 0.145% of filed returns in 1981 versus 2.793% of returns in 2009). Thus the \$200,000 level corresponds to a percentage of individual income tax returns that is about twenty times higher than it was when the number was put into Reg D in 1981.

²⁰² Jumpstart Our Business Startups Act, Pub. L. No. 112–106, § 201, 126 Stat. 306, 313–15 (2012) (amending 15 U.S.C. 77d). See *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Securities Act Release No. 9415 (July 10, 2013) 78 FR 44771 (July 24, 2013).

distributions.²⁰³ That the ban on general solicitation was implicit in *Ralston Purina* and its progeny might be right historically but so was a bona fide sophistication or access requirement, both of which were effectively ignored. Once policymakers were willing to radically reorient the latter in the name of small-business capital raising by substituting wealth for sophistication and access to information as the standard for qualification, there was no reason to be overly fastidious about the former simply to respect precedent. So why keep the ban in place if it was dampening capital formation?²⁰⁴

We agree there is no good answer when the question is posed this way, which raised the possibility that the main function played by the ban was just to enrich the broker-dealer industry—a pure public-choice story. Our point here, however, is a broader one. As noted, Reg D's controversial choice to shift to a wealth-based standard was muted by five features that were present then but now have either diminished in potency or disappeared entirely.²⁰⁵ Accredited-investor status is no longer for the very well off by virtue of inflation over time and now encompasses a broad swath of retail investors in the United States—indeed, most serious proposals to eliminate the ban on general solicitations were coupled with proposals to adjust the qualification standard upward fairly significantly.²⁰⁶ The resale holding period has been shortened by two-thirds. *Gustafson* has taken away negligence-based liability for misrepresentations or actionable omissions in resales and private placements. State regulation is preempted. And now the ban has gone away too.

In other words, the sequence of changes culminating in the JOBS Act has given us Rule 506 as applied to sales to accredited investors in a much more pure, unadulterated—and thus more potent—form. That the elimination of the ban on general solicitation preserves con-

²⁰³ See Securities Act Release No. 9415 (adding Rule 506(c) which, among other things, requires issuers to take reasonable steps to verify that a purchaser in a Rule 506 offering with general solicitation is an accredited investor and provides nonexclusive safe harbors methods of verification so long as the issuer does not know that such person is not accredited).

²⁰⁴ See Cohn, *supra* note 189, at 359–60 (analyzing the adverse impact of restriction on solicitation on small companies' offerings); see also Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & Bus. 1, 1 (2007) (examining the principal hurdles facing small businesses seeking to raise capital and offering reform recommendations).

²⁰⁵ See *supra* text accompanying notes 181–85; see also Jennifer J. Johnson, *Private Placements: A Regulatory Black Hole*, 35 DEL. J. CORP. L. 151, 176–79 (2010) (questioning the continued value of the federal preemption of state regulation of private placements).

²⁰⁶ See FINAL REPORT OF THE SEC ADVISORY COMMITTEE, *supra* note 161, at 77 (proposing that two million dollars of net worth or three hundred thousand dollars of annual income be required qualifications to be considered a natural person accredited investor). The Advisory Committee called for a new exemption allowing certain kinds of general solicitations but with an increase in the wealth test for determining qualified investors. See *id.* at 74–81.

sistency with the underlying assumption of Reg D is less compelling when we remember that Reg D was never really debated in pure form when the assumption was made.

Revisiting that question thoroughly would take us beyond the scope of our current project and into the foundational debate in corporate securities law about contractual freedom and legal intervention. The point we want to stress, once more, is that as distributions of securities move from bargaining with a small group of buyers to mass marketing directed at a large, dispersed group of well-off retail investors, the likelihood of successful opportunism grows. In theory, of course, the presence of a critical mass of sophisticated buyers will reduce the likelihood of opportunism even if we assume some unsophisticated buyers.²⁰⁷ Successful marketing makes it necessary to go beyond them and appeal to the rational buyers. But that protection works only if products cannot be differentiated so that some are marketed to those who truly can fend for themselves while others are sold to the vulnerable.²⁰⁸ And if the vulnerable market is large enough, there are incentives to find and sell hidden risk in the name of seductive returns through financial products targeting that segment of the investor marketplace.²⁰⁹

Ultimately, the question of whether large numbers of accredited investors are vulnerable through the steroidal form of Rule 506 that the JOBS Act creates is an empirical one. Data is lacking on the performance of Reg D offerings that would permit a confident assessment. The anecdotal evidence of abuses is considerable—for example, nearly eight billion dollars of Prudential Securities' tax-sheltered limited partnership interests went bust, leading to large settlements with regulators and investors in the early 1990s.²¹⁰ More recently, failures to appreciate risk by even institutional buyers of securitization and derivative products strongly suggest that the ability of investors to fend for themselves is fictional if the investment is complicated enough. FINRA had been warning about Reg D abuses for a

²⁰⁷ See Alan Schwartz, *How Much Irrationality Does the Market Permit?*, 37 J. LEGAL STUD. 131, 151 (2008) (concluding that the likelihood that markets will generate normatively desirable contract terms increases in part in the number of sophisticated consumers).

²⁰⁸ See, e.g., Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSP. 161, 180 (2004) (suggesting a rule change that "harness[es] the monitoring efforts of institutional investors for the benefit of unsophisticated investors" in investment vehicles that include both sophisticated and unsophisticated investors). For a lengthier discussion of the implications of this for retail investor protection, see Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1042-58 (2009).

²⁰⁹ For an example at the extreme end of such behavior, see Laura Frieder & Jonathan Zittrain, *Spam Works: Evidence from Stock Touts and Corresponding Market Activity*, 30 HASTINGS COMM. & ENT. L.J. 479, 506 (2008) (concluding that spamming works in stock markets from the analysis of touting e-mail messages' impact on trading activity and returns).

²¹⁰ The story is well told in KURT EICHENWALD, *SERPENT ON THE ROCK* (2005).

number of years²¹¹ before the ban on general solicitation was repealed. New SEC proposals, made the same day it promulgated the final general solicitation rules, would insist on warning legends in soliciting material and provide more information to the Commission about the particular offering in order to enhance regulatory monitoring,²¹² but the opportunity for more intense sales efforts would remain.

Well-off senior citizens are a particularly troubling target of opportunity.²¹³ Skirmishing over accredited-investor status in the debate leading up to the Dodd-Frank Act did take away home equity as part of the one-million-dollar-in-wealth calculation, reducing exposure that was created by the use of once-highly-profitable home ownership as a base for retirement security.²¹⁴ But we have seen that retirement savings still count, and a retiree who has a lump sum to invest to provide for all of life's remaining needs beyond what is protected by Social Security, Medicare, and other sources can certainly be "wealthy" enough to be accredited and yet be extraordinarily vulnerable.

The anecdotal evidence of abuse through sales pressure to date has arisen even though the selling is being done by registered broker-dealers who have obligations to know the security being recommended, to make only suitable recommendations, and the like. That is troubling enough, a manifestation of the difficulty of enforcing sales-practice regulation that we discuss more in Part IV. But the JOBS Act invites new and less regulated actors into the selling arena, suggesting that regulatory control may weaken even further.²¹⁵

So the Rule 506 reform is the place where the JOBS Act makes the clearest trade-off between capital formation and investor protection. Perhaps the boost to entrepreneurial capital raising will be worth the harm from more aggressiveness in this area, but that is far from sure. Should this area become more notorious for abuse, it could have the opposite effect, causing some capital to move away

²¹¹ See FINRA, REGULATORY NOTICE 10-22, *supra* note 199, at 2.

²¹² See Amendments to Regulation D, Form D and Rule 156 under the Securities Act, Securities Act Release No. 9416 (July 10, 2013) 78 FR 44806 (July 24, 2013) (proposing to require filing of Form D before engaging in general solicitation, adding legend to written general solicitation, and requiring submission on a temporary basis of written general solicitation material). In the same release, the Commission requested comment on revising the definition of accredited investor. The proposals, approved by a 3-2 vote, were immediately controversial. See Split SEC Clears JOBS Act Advertising Rules, Issues Proposals on Enhanced Requirements, 45 Sec. Reg. & L. Rep. (BNA) 1285 (July 15, 2013).

²¹³ See generally Jennifer J. Johnson, *Fleeing Grandma: A Regulatory Ponzi Scheme*, 16 LEWIS & CLARK L. REV. 993 (2012) (examining the vulnerability of individuals, or "retail investors," under the current regulatory scheme).

²¹⁴ See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 413(a), 124 Stat. 1376, 1577 (codified at 15 U.S.C. § 77b note (Supp. V 2011)).

²¹⁵ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 304, 126 Stat. 306, 321-22 (2012) (to be codified at 15 U.S.C. § 78c(a), (h)) (regulating funding portals).

from start-up investments. While we are sympathetic to the logic of removing the ban, we would make other changes to moderate its impact—most obviously by revising the definition of accredited investor. And as we explore more deeply in the next subsection, there were constructive opportunities for reform with respect to liability and due diligence that Congress ignored.

This discussion should amply show why the new Rule 506 environment should trump either crowdfunding or the new Reg A+ for any issuer that could possibly imagine a positive reception (after aggressive marketing) in the expanding accredited-only markets. Obligations and liability risks are deeply suppressed at the initial capital-raising stage. If the issuer is indeed successful, an acquisition by a larger company—which increasingly has become the most common form of “exit” from start-up status—is more attractive if all the start-up’s investors are accredited because that acquisition will be exempt under Rule 506 too.²¹⁶ In fact, we are reasonably sure that this accredited-only form of capital raising will come to dominate the IPO as well for many of the same reasons except in those situations where the issuer’s success is so dramatic that access to public investment makes the regulatory costs (and the ceding of power to the demands of publicness) worthwhile.²¹⁷ For an increasing number of issuers, we suspect this tradeoff will not be worthwhile and other portions of the JOBS Act accommodate those who wish to remain private, perhaps indefinitely, even if their shares have a relatively high degree of liquidity.²¹⁸

4. *Gustafson Revisited*

As resale limits and the general solicitation ban have receded in Rule 506 transactions, the effect of *Gustafson* looks far different than when it was decided in 1995. At that time, Rule 506 was closer to its private-placement roots in a world of negotiated deals where contract law could do more of the work. Indeed, the case itself arose in a factual setting of face-to-face negotiations of a transaction in the resale

²¹⁶ Acquisitions using stock as consideration must be registered absent an exemption, and Rule 506 is often used to acquire a private company when all of its shareholders are accredited investors. This is typically the first step in a reverse merger as noted in Part II. See Sjoström, *Truth About Reverse Mergers*, *supra* note 21, at 746–48.

²¹⁷ See VLAD IVANOV & SCOTT BAUGUESS, SEC. & EXCH. COMM’N, CAPITAL RAISING IN THE U.S.: THE SIGNIFICANCE OF UNREGISTERED OFFERINGS USING THE REGULATION D EXEMPTION 3 (2012), available at http://www.sec.gov/info/smallbus/acsec/acsec103111_analysis-reg-d-offering.pdf (presenting an economic study by the SEC showing that Reg D in 2010, even before dropping the ban on general solicitation, produced eight percent more capital than public offerings).

²¹⁸ The JOBS Act extends the ability of a private company to avoid ‘34 Act regulation so long as it has fewer than 2000 record shareholders, not more than 499 of which are nonaccredited. See Langevoort & Thompson, *supra* note 13, at 338–39.

market that included extensive representations and warranties.²¹⁹ In the post-JOBS Act world, the focus will be private placements that are exempt from the full registration requirements of the '33 Act but that still reflect significant selling efforts. Why would a securities regulation structure based on the four requirements we have described want to leave enforcement of such private placements to state law, a geographically limited system that had proven inadequate in a post-1929 world? *Gustafson* returned us to that world with no recognition then or in the years since that the world of private offerings has changed so dramatically.

The private cause of action under Rule 10b-5 continues to provide a possible remedy so long as the plaintiff can meet the requirements of that rule, a remedy that once (but no longer) could be described as substantively broader than common law fraud.²²⁰ That more intent-based liability system is closer to the fraud-based common law system than the due diligence approach that the '33 Act applies to securities offerings, which we have characterized as reflecting the concern for special selling efforts.

Taking Rule 506 so much closer to its radical vision underscores the original question—when private offerings are sold rather than negotiated, are we confident enough that accredited investors can fend for themselves? Here we find *Gustafson's* biggest and most troubling impact: the more aggressive the selling (and the more dispersed and attenuated the individual investors), the more concerning any absence of due diligence (and other rite-of-passage consequences) behind the marketing.²²¹

Some accredited investors will be savvy enough, but as just noted, we have no evidence supporting the idea that most do or will when faced with such a diverse and opaque financial-product mix. As with reverse mergers and PIPEs, due diligence is the missing piece. The less threatening JOBS Act reforms (crowdfunding and Reg A+) seem to have recognized this as they expressly contain due diligence liabil-

²¹⁹ See *Gustafson v. Alloyd Co.*, 513 U.S. 561, 564 (1995) (noting that the only three shareholders of Alloyd, Inc. contracted to sell it to a single purchaser).

²²⁰ See Robert B. Thompson, *Federal Corporate Law: Torts and Fiduciary Duty*, 31 J. CORP. L. 877, 884 (2006) (describing the change from the Supreme Court's pronouncements in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), that Rule 10b-5 departures from common law were in the direction of adding to the protections provided investors by the common law, to a regime under which Rule 10b-5 resembles the common law).

²²¹ We are more interested here in the due diligence than mandatory disclosure *per se*. Our suspicion is that private placement memoranda are commonplace even when not legally required, and we share the view expressed by many that the disclosure itself is often unread. The function of due diligence is as much to discipline the offering participants as it is to facilitate good investment decisions, especially when high-pressure sales techniques are employed. That said, we assume that accurate disclosure documents will be helpful to at least some investors.

ity. But this recognition is obscured in the Rule 506 context by the “logic” of allowing general solicitation of anyone who is accredited. The private-placement exemption, in other words, now may have taken on more weight than it can bear.

The reality is that with the removal of the general solicitation ban for Rule 506 offerings, this most-used exemption is now available with no mandated disclosure, with no limits on the selling process and without the usual incentives for due diligence found elsewhere in securities selling. Since *Gustafson*, liability is not a factor as far as the ’33 Act is concerned. Yet, a recent study by the economists at the SEC showed specifically that private offerings produced more capital than public offerings; in 2010 and the first quarter of 2011, Regulation D was the largest source of capital.²²² What the JOBS Act does is open those investors to a new world of aggressive selling, including that coming via the Internet. With the demise of the ban on general solicitation, we can expect more aggressive selling than we have seen in the past. This will put pressure on the existing equilibrium, including the lack of due diligence incentives and liabilities. It is also possible that the general solicitation now permitted for private placements will help create a buzz that lingers in the electronic cloud so as to facilitate greater selling in a resale market.

We think that section 12(a)(2) in an updated form should be applied in any context likely characterized by heavy sales pressure with respect to a significant volume of securities—our vision of what justifies ’33 Act-style regulation in the first place—even if not through full-scale registration. That is the new world of Rule 506. Absent more protection, general solicitations to accredited investors (as currently defined) threaten a great deal of harm.²²³

5. *Organized Resale Markets*

One of the lingering questions in the aftermath of the JOBS Act has to do with the resale of privately placed securities through organized trading markets. As we have discussed elsewhere, a significant feature of the Act was to make it easier for “pre-public” companies to raise capital privately and not have to worry as much that they will be forced into ’34 Act publicness because they find themselves with five hundred or more shareholders of record. The number is reset to

²²² See IVANOV & BAUGUESS, *supra* note 217, at 3.

²²³ Still, we recognize that the economics of section 12(a)(2) litigation are complicated. Where the amount of capital raised is limited, the incentive of plaintiffs’ lawyers to undertake litigation on behalf of dispersed investors may be limited as well because of a meager expected return after the costs of litigation, and there may be serious hurdles to class certification. However, restoring due diligence-based liability at least improves plaintiffs prospects, and so restoration would presumably have some positive effects on those incentives and thus on the level of care that goes into the deals *ex ante*.

2000, so long as no more than 499 of those are nonaccredited investors.²²⁴

The reference here to accredited investors creates a curious mash-up of '33 and '34 Act concepts. Until the JOBS Act, the '34 Act had not used investor sophistication or ability to bear risk to define when issuers take on publicness obligations. The likely, and presumably intended, consequence of the new formulation is to encourage issuers to participate in private resale markets available only to accredited investors. That should assure that such markets will be important as alternative trading sites.

To this point, our discussion of the elimination of the ban on general solicitations has assumed that issuers would make aggressive Rule 506 offerings, with the securities "locked up" for (just) one year before they move—aggressively perhaps—to the public markets in search of greater liquidity and depth of investor interest. But that would take the issuer to public status under the '34 Act even if '33 Act registration was bypassed. An alternative would be to bypass both regulatory systems by staying *indefinitely* in the private, accredited-only markets and making sure that the number of record shareholders stays below two thousand. As we have described elsewhere, the latter task might not be terribly hard for a savvy lawyer.²²⁵

This deserves more attention than it has been given. Consider the following sequence: The issuer makes a large-scale capital raise by aggressively targeting the growing population of accredited investors, doing so without any '33 Act registration. After a one-year holding period, the securities are freely tradable among accredited investors with the issuer taking sufficient precautions to monitor the number of record shareholders so as not to trigger '34 Act registration. No rite of passage ever takes place. To emerging growth companies (whom the JOBS Act otherwise tries to tempt into an IPO through its on-ramp), this has to be an attractive proposition.²²⁶ If securities regulation is indeed severely discouraging to entrepreneurs, this in all likelihood dominates as a strategy. The resulting threat to public markets like NASDAQ and NYSE is palpable.

That, of course, assumes that accredited investors—retail as well as institutional—will participate in these markets in sufficient numbers to achieve the necessary depth and liquidity. We can make no confident prediction other than to say that *if* such private markets became the location of choice for highly successful emerging growth companies, investor interest would follow (a bit like the migration of

²²⁴ Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 501, 126 Stat. 306, 325 (2012) (amending 15 U.S.C. § 78l(g)(1)(A)).

²²⁵ See generally Langevoort & Thompson, *supra* note 13.

²²⁶ See Jumpstart Our Business Startups Act §§ 101-108.

qualified investors to hedge funds rather than mutual funds). This would provide a context in the nature of a natural experiment to test the value of mandatory disclosure and the associated rites of passage, which the private markets could partially offset in their favor by insisting on a certain commitment to ongoing disclosure through contractual listing standards. The JOBS Act all but sets this experiment in motion.

An interesting technical '33 Act question lurks here. It seems clear that free trading among accredited investors is permissible after a year, but why not before? Doesn't the assumption that accredited investors can fend for themselves mean that resales should be freely permissible at any time? With respect to the crowdfunding exemption, the JOBS Act says precisely that.

Yet there is a gap here. Rule 144 addresses resales of restricted securities, providing a safe harbor for resales that meet its clearly defined holding period. Alternatively however, through what is colloquially known as the common law "4(1½)" exemption,²²⁷ resales are permissible if made to persons who do not need the protection of registration, which takes us directly to the issues posed here. But the need for protection references back to *Ralston Purina* and its uncertain interpretations because Reg D's alchemy for accredited investors does not work with respect to resales the same way that it does for initial sales by issuers to investors. And when the SEC did turn to this question explicitly in the 1990s via Rule 144A, it authorized free resales only among "qualified institutional buyers"—a category far more exacting than that of "accredited investor," limited to institutions with at least a hundred million dollars in their investment portfolios.²²⁸ The subtle legal point here is that even if we assume sophistication on the part of the resale buyer, that buyer lacks the leverage with the issuer necessary to gain the access to information so stressed in *Ralston Purina*. Hence, without an express provision such as that found in the crowdfunding exemption²²⁹ (or a radical amendment to 144A), resales within the one-year period are legally risky.

We are somewhat surprised that Congress did not do this. Doing so would have been easy and consistent with the themes that resonate throughout the JOBS Act. But because it did not, this small '33 Act speed bump remains in the road to the development of alternative private markets.

²²⁷ See *supra* note 107 and accompanying text.

²²⁸ See 17 C.F.R. § 230.144A(a) (2013). For a discussion of this provision, see Cox ET AL., *supra* note 66, at 374–80.

²²⁹ The new crowdfunding exemption explicitly allows resales by crowdfunders to accredited investors but leaves unclear the treatment of any resales after that. See Jumpstart Our Business Startups Act § 301(b) (adding section 4A(c) to the '33 Act).

IV

REGULATING SALES PRACTICES AS A '33 ACT SUBSTITUTE

Our three case studies illustrate fairly starkly that we have not yet developed an adequate account for why there is still a need for a '33 Act once we assume that the '34 Act works to make trading markets more transparent (especially as technology increases that transparency).²³⁰ One intuition developed here is that the '33 Act is meant to guide the transition from private to public—the rite of passage that supposedly helps assure that the newly public issuer is up to the burdens of publicness. But that is an expensive endeavor that presumably dissuades certain issuers from raising capital publicly, and it is not self-evidently worth the costs. Reverse mergers and PIPEs meet a demand for alternative capital-raising devices and have generated enough success (though the record is surely mixed) that we should be open to other forms of innovation in the '33 Act area with substitutes for heavy-handed registration. Rule 506 was ripe for reform, though what the JOBS Act does may not leave us in the right place.

Our central point in the foregoing is that the major indicator of the need for regulatory intervention under the '33 and '34 Acts is the likelihood of sales pressure.²³¹ That takes us to how that sales pressure is best addressed. Burdening issuers with extensive disclosure obligations may not be the best way of addressing the risk that its stock price is being pumped, especially for investors whose investment decisions are not necessarily driven by issuer-specific information.²³² And litigation-based enforcement has its own set of concerns. To the extent that sales practices are what we are increasingly worried about as markets fragment and become more technologically sophisticated,

²³⁰ The three cases do not exhaust the examples of special selling efforts occurring in a setting with only the less intense regulatory requirements of the '34 Act. The credit default swaps sales that got Goldman Sachs in so much political hot water in the run-up to the passage of Dodd-Frank present a similar combination. Goldman argued that it was merely a dealer making a market with both a buyer and a seller. But Goldman's interest was not that of a neutral market maker, equally exposed to both sides of a trade. Rather, it had helped create a special-purpose vehicle that was the nominal issuer of the securities and had undertaken a large selling effort to drum up interest on the long side of the swaps. It did this for the benefit of its hedge fund client who sought more securities that would permit him to take the short side of the swaps, which would pay off if the housing market declined. The result, also parallel to our other examples, was the absence of an underwriter or other person providing due diligence even though there were aggressive selling efforts and a dump of securities on to the market. See Robert B. Thompson, *Market Makers and Vampire Squid: Regulating Securities Markets After the Financial Meltdown*, 89 WASH. U. L. REV. 323, 337–42 (2011).

²³¹ There is evidence that the commissions from selling private placements far exceeds other kinds of investments, and FINRA's efforts to cap commissions even at the high level of fifteen percent was defeated by industry resistance. See Johnson, *supra* note 213, at 995 n.9.

²³² See Rajesh K. Aggarwal & Guojun Wu, *Stock Market Manipulations*, 79 J. BUS. 1915, 1936 (2006).

maybe the right response is not to fiddle with the line separating public and private offerings but instead to target the salespeople and their firms. In other words, some of the issues we have been discussing might better be considered the concern of the SEC's Division of Trading and Markets (in cooperation with FINRA) rather than its Corporation Finance division, the traditional focus of this regulation. As a historical matter, it is worth noting that when the '33 Act was written, there was no systematic broker-dealer regulation (that arrived three years later, even after the '34 Act was originally adopted)²³³ and so perhaps a useful integration project with respect to the two statutes is to see how much of the response to the risk of sales pressure could be moved to the other statute.

In fact, with respect to Reg D, FINRA had tried to respond to perceptions of abuse through greater broker-dealer due diligence²³⁴ and disclosure responsibilities. The disclosure effort, however, was watered down, and when the SEC finally approved the new requirements in the aftermath of the JOBS Act, it actually highlighted the elimination of mandatory disclosure as a capital-formation-friendly step.²³⁵ In the end, neither the SEC nor FINRA seemed to want to go against the political winds of 2012.

The sales-practice regulation we have in effect today is not particularly efficient. The problem is that broker-customer interactions occur in person, over the phone, and (increasingly) through electronic media—including social media—in numbers and ways that are simply impossible for regulators to monitor. The penny-stock rules of the early 1990s tried to disrupt the worst of the selling practices,²³⁶ but they did so largely through consent and paperwork burdens that seem decidedly old-fashioned just a couple of decades later. The result is that regulators have increasingly outsourced compliance responsibilities to registered broker-dealers themselves through enhanced internal supervision and record-keeping duties. Some firms do better at this than others, and the costs are considerable.

The impending “fiduciarization” of the broker-dealer community is occasion for a thorough review of broker-dealer sales practices, including the circumstances under which brokers should be promoting and recommending particular stocks in which they have a conflicting

²³³ See SELIGMAN, *supra* note 23, at 141–48.

²³⁴ See *supra* note 199. FINRA's “know your security” standard requires due diligence, and this has been imported into the case law in this area. However, in private litigation under Rule 10b-5 at least, there must be scienter and not mere lack of diligence. See COX ET AL., *supra* note 66, at 1031–35.

²³⁵ Approval of FINRA Rule 5123, Exchange Act Release No. 67,157, 2012 WL 2061577 (June 7, 2012).

²³⁶ See Joseph I. Goldstein et al., *An Investment Masquerade: A Descriptive Overview of Penny Stock Fraud and the Federal Securities Laws*, 47 BUS. LAW. 773, 774–75 (1992).

interest. This is too big and daunting a topic to address here, however.²³⁷ Ultimately, the art of high-pressure salesmanship probably defies regulatory control at the point of sale, and existing rules and regulations already prohibit most of the tried-and-true tactics associated with pumps and dumps.

The real question is one of surveillance—knowing on a real-time basis where the risky “neighborhoods” are so that policing can be better targeted. Here, the question becomes whether the SEC’s own technology (or FINRA’s) could take feeds from all the various facilities that execute trades so as to draw “hot maps” that show sales pressure at work. This, however, should be SEC-wide. For instance, it seems technologically feasible to know, on a firm-by-firm basis, what securities are being sold to customer accounts in amounts that suggest heavy sales pressure (i.e., volume or frequency substantially above normal parameters for a particular stock). It is also possible to determine how frequently such evidence of pressure correlates with capital-raising efforts by issuers and affiliates (including sales under Reg D, PIPEs, and reverse mergers), as well as whether such sales pressure conforms to the pattern associated with pumping and dumping—for example, price inflation during the time of the pressure followed by deflation later on so that customers who hold the stock eventually lose money. The result of all this would be to allow officials to develop statistics that rank firms in terms of likelihood of applying sales pressure posing the kinds of risks that we have been discussing.

That would be useful information to say the least. It would allow regulators to target risky selling arrangements with fewer prophylactic, “one size fits all” rules. To our knowledge, even though the SEC and FINRA are spending more to upgrade their own technology, this ability—though amply feasible and no more sophisticated than much of what the securities industry puts to use—is still far beyond current regulatory capacity, although FINRA has taken useful first steps toward the electronic filing of some private placement-related materials.²³⁸ The kind of surveillance we are talking about extends this to the over-the-counter world, where the costs and threatened burden on innovation would no doubt trigger ever more pushback.

²³⁷ For treatment of this topic, see, for example, Arthur B. Laby, *Reforming the Regulation of Broker-Dealers and Investment Advisers*, 65 BUS. LAW. 395 (2010); Donald C. Langevoort, *Brokers as Fiduciaries*, 71 U. PITT. L. REV. 439 (2010).

²³⁸ See Proposed Rule Change Relating to Members’ Filing Obligations Under FINRA Rule 5123 (Private Placements of Securities), available at <http://www.finra.org/Industry/Regulation/FuleFilings/2013/P285315> (June 20, 2013). The effort to build a consolidated audit trail at the stock-exchange level, meant to allow better regulatory surveillance of the kind of market-trading activity that led to the “flash crash” in May 2010 shows that this can be done—albeit at great cost and controversy. See Consolidated Audit Trail, Exchange Act Release No. 67,457, 2012 WL 2927797, at *9 n.45, *18–19 (July 18, 2012) (adopting release).

But technology-enhanced surveillance need not be this intrusive to be helpful. Some element of electronic self-reporting by broker-dealers whenever their trades exceed more than a certain threshold of volume in a particular issuer's stock could offer greater transparency than we now have, so long as the SEC (or FINRA) inspection process could check for compliance with the reporting obligation.

If successful, such surveillance could have substantial benefits, easily justifying greater deregulation in the '33 Act area and perhaps the '34 Act as well. Assume, for example, that we had these sorts of hot maps that located unusual sales activity in stocks recently registered as PIPEs or in the aftermath of a reverse merger, or a new general solicitation of accredited investors. The regulatory ability to intervene on a real-time basis to observe the quality of information surrounding that kind of sales pressure would precisely target what we are worried about. There would be less importance to the '33 Act treatment if this were under control. But it would take a large investment in new-style regulation for this to happen, and it is far from clear that we are in a political environment that wants and is willing to pay for it.

CONCLUSION

Our intuition is simple enough: the '33 Act is driven by concern for the sales pressures that come from having to dispose of a significant volume of securities in a short time and the risks of deception and opportunism that may result. As more and more hybrid and other novel techniques emerge for selling securities, the appropriate regulatory approach is to ask how serious this concern is with respect to any such type of transaction; the more serious, the more we need some mix of strategies from the '33 Act template in response. This is not to say that IPO-style registration is always—or even usually—appropriate. For each of the case studies that we have done here, the point is not to call for a return to full registration so much as to identify something missing in the prevailing patched-together, exemptive approach. In each, it turns out that our main concern is about the disappearance of due diligence as a discipline on the selling process and the constructive role that a more capacious liability threat—perhaps by means of section 12(a)(2), unnecessarily truncated in *Gustafson*—could play to supplement limited regulatory resources.

Our ambition here has been conventional: developing a theory to explain the '33 Act and using that theory to address some powerful contemporary changes in capital-market activity. At least from that perspective, we are convinced that as entrepreneurial capital-raising techniques evolve and the JOBS Act innovations take root, policymak-

ers should try to assure that constructive deregulation does not channel too many securities transactions into places with too much fog and not enough sunlight.

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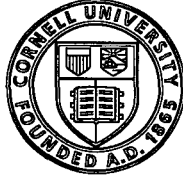
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